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Witness *Mark L. Oligschlaeger*
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MISSOURI PUBLIC SERVICE COMMISSION

COMMISSION STAFF DIVISION

AUDITING DEPARTMENT

SURREBUTTAL TESTIMONY

OF

MARK L. OLIGSCHLAEGER

MISSOURI-AMERICAN WATER COMPANY
GENERAL RATE CASE

CASE NO. WR-2017-0285

Jefferson City, Missouri
February 2018

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MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2017-0285

Q. Please state your name and business address.

A. Mark L. Oligschlaeger, P.O. Box 360, Suite 440, Jefferson City, MO 65102.

Q. Are you the same Mark L. Oligschlaeger previously contributed to Staff's Cost of Service Report ("Staff Report") and submitted rebuttal testimony in this proceeding?

A. Yes, I am.

<u>EXECUTIVE SUMMARY</u>

Q. Please summarize your surrebuttal testimony in this proceeding.

A. In this testimony, I will address some of the points made by Missouri-American Water Company (MAWC) witness James M. Jenkins in his rebuttal testimony in this proceeding regarding the future test year issue. I will also discuss Mr. Jenkins' recommendations for rate treatment of some aspects of the implementation of the recently enacted Tax Cuts and Jobs Act (TCJA).

<u>FUTURE TEST YEAR</u>

Q. At page 7, lines 7 -13, Mr. Jenkins implies that use of a future test year would enable the Commission to incorporate the recent changes in federal tax law in the TCJA in customer rates in this proceeding while continued use of the historic test year model would not. Is this accurate?

A. No, not at all. The ordered true-up period for this rate case ends December 31, 2017. The TCJA went into effect on January 1, 2018. There has been a long-standing practice by the Commission that changes effective immediately or "one second" outside the test year or true-up period are not considered to disturb the revenue-expense relationship established within the test year and true-up period.[1] Within its traditional historical test year practices, the Commission can fully consider the ratemaking implications of the TCJA in the confines of its ordered audit periods in this case.

Q. Will incorporation of the TCJA impacts on MAWC income tax expense in this rate case result in an appropriate matching of that item with other components of revenue, expense and rate base in this case?

A. Yes. All material components of this case will be updated through the end of 2017, concurrently with the implementation date of the TCJA. Starting on January 1, 2018, the income tax expense associated with the ongoing earned income amounts of MAWC will be recorded by MAWC using the new tax rates and rules starting on January 1, 2018.

Q. In several sections of his rebuttal testimony, Mr. Jenkins claims that MAWC's proposed future test year results are appropriately matched. Do you agree?

A. No. I pointed out several instances in my rebuttal testimony where MAWC has appeared to include certain costs in its estimates but did not choose to project any savings resulting from the expenditures (water losses, main breaks) for incorporation into its case. Based upon my review of the recently approved ten-year MAWC 2018-2027 operating budget, I have identified another example of apparent faulty matching.

[1] ***In re Kansas City Power & Light Company***, 21 Mo. P.S.C. (N.S.), 543-597, at 573-574, (Decided October 20, 1977).

Q. Please explain.

A. The part of salary/wage expenditures incurred by utilities related to the ongoing operation of the business is charged to operations and maintenance (O&M) expense, and the part pertaining to construction activities is capitalized to construction projects. The revenue requirement associated with expensed payroll is higher than the revenue requirement for the same dollar amount of capitalized costs. In the current budget for year 2018, one of the assumptions listed by MAWC is a payroll capitalization percentage of 43.5%. This means their budget reflects an assumed assignment of payroll related costs to O&M expense of 56.5% in 2018.

Q. Did MAWC assume this or a similar payroll capital percentage in its future test year projections?

A. No. MAWC's proposed payroll capitalization percentage for its future test year is 42.3%, the actual payroll capitalization percentage it incurred for the twelve months ending December 31, 2016. For purposes of their future test year, this means that MAWC is assuming that 57.7% of payroll should be assigned to O&M, and not to capital projects.

Q. What has MAWC identified as the recent trend in the amount of its capital expenditures?

A. As previously stated in my rebuttal testimony at pages 9 - 10, the total amount of MAWC's budgeted capital expenditures for 2018-2019 are higher than in recent years.

Q. How is MAWC's stated position on the payroll capitalization percentage an example of inappropriate matching within MAWC's proposed future test year?

A. Capital costs partly consist of payroll charges (i.e., the salaries of those utility employees supervising or performing labor on the capital projects). To the extent there is an increase in the proportion of payroll costs subject to capitalization, the percentage of payroll charged to O&M expense should proportionately decrease. However, MAWC's position in this case effectively seeks to charge customers rates based on an assumed higher payroll O&M expense percentage value from 2016 and higher labor costs assumed to be capitalized to construction in 2018 and 2019 within its forecasted plant in service amounts. If adopted, this position essentially would result in MAWC receiving double recovery in this case of a portion of MAWC's payroll costs, and does not constitute appropriate matching of expenses and rate base.

Q. Are the dollars associated with capitalized payroll percentages potentially material?

A. Yes. When applied to Staff's payroll, benefits, pension/OPEBs and group insurance adjustment calculations, the difference between MAWC's budgeted 2018 payroll capitalization percentage (43.5%) and the percentage actually recommended by MAWC in this rate (42.3%) case is worth approximately $870,000.

Q. You previously stated that you recently reviewed MAWC's 2018 – 2027 operating budget. What level of operating expenses is reflected in the budget?

A. I have presented MAWC's budgeted operating expense amount[2] for 2018 below, as well as the comparable amounts for the years 2014 – 2017:

2018	$132, 810,000
2017	$124,482,000
2016	$122,675,000
2015	$121,208,000
2014	$123,574,000

[2] Consistent with the presentation of similar actual numbers in my rebuttal testimony, all "operating expense" amounts presented include MAWC's operations and maintenance expenses, but exclude depreciation and amortization expense, and all taxes.

Q. Is the budgeted level of operating expenses for 2018 consistent with the level forecast by MAWC in its future test year proposal?

A. Generally, yes. What is striking about the 2018 budgeted amount is how much higher this value is compared to the budgeted amounts for prior years. This is consistent with MAWC's test year proposal, which likewise features a sharp escalation in forecasted operating expenses in this case compared to actual incurred amounts in recent years.

Q. In his rebuttal testimony at page 14, lines 5 - 17, Mr. Jenkins' criticizes MIEC witness Greg R. Meyer for inconsistency for allegedly not recognizing that his criticisms of the future test year approach are also applicable to historic test year ratemaking. Please comment.

A. I interpret Mr. Jenkins' argument to say that criticisms the claim that the future test year approach to setting rates is inherently speculative miss the point in that historic test year results should be viewed as being just as "speculative" in relation to the amount of the utility's actual cost of service at a future point. Staff agrees in part with Mr. Jenkins, but disagrees in part on this contention as well. Further, even Staff's partial agreement does not mean it shares Mr. Jenkins' conclusions on this topic.

Q. In what respect do you agree with Mr. Jenkins?

A. Staff agrees that all ratemaking, whether produced through a historic test year or future test year, is inherently uncertain. This is because ratemaking in theory should produce rates that cover a utility's cost of service in the period rates will be in effect. However, the utility's rate filing, rate audit, evidentiary hearings and Commission decision by necessity all predate the period when rates will be in effect. Also, and obviously, no one can forecast with any level of certainty what a utility's cost of service will be in the future. For this reason, ratemaking unavoidably relies on "estimates" of what a utility's future cost of service will be – whether based on historic data or future forecasts. In a historic test year, those estimates/projections are constructed based on known and measurable actual utility financial data. In a future test year, those estimates/projections are largely based on budgets and forecasts.

Q. In what respect do you disagree with Mr. Jenkins?

A. Staff disagrees with Mr. Jenkins' implication that use of historic test years is no more justified or perhaps less justified than use of future test years since both methods use "proxy values" in place of unknown future financial results. In the current circumstances facing Missouri utilities, Staff's view is that historic test year ratemaking is, in fact, superior to the future test year model in that it is underpinned by actual utility financial results and provides meaningful incentives for utility productivity and efficiency. As previously discussed in the Staff Report and in rebuttal testimony, future test years are inherently more subject to bias on the part of the utility constructing the forecast, and less effective in incenting a utility to operate at the lowest reasonable cost of service, than if historical test years are utilized.

Q. Mr. Jenkins' refers several times to reliance on "stale" and outdated data to set rates in the context of historic test years. Is "stale" data a problem with historic test years?

A. It can be. That is why it is crucial to thoughtfully employ annualization and normalization techniques to utility financial results in order to better ensure customer rates are set using the most current trends in utility expenses, revenues, rate base and cost of money. Historical test year ratemaking, if done properly, does not rely on stale or outdated data.

Q. At various places in his rebuttal testimony, Mr. Jenkins' expresses a belief that Staff and other parties' use of terms such as "known and measurable" (page 21, lines 7 - 18) and "used and useful" (page 14, line 23 through page 15, line 6) are too restrictive, and that such concepts can fit into the future test year construct. Does Staff agree?

A. No. Mr. Jenkins is only correct if one fundamentally changes the definitions commonly applicable to those terms. On its face, an estimated cost cannot be "known and measurable" as that term has been understood in the past in Missouri rate regulation. In the same manner, a planned future plant in service addition cannot be "used and useful" if it is not yet in-service, if the traditional meaning of that term is to be adhered to.

Q. At pages 15 -16, Mr. Jenkins appears to imply that application of the traditional "used and useful" standard is unfair as it would not guarantee the utility will receive timely rate recovery of plant addition costs once the projects are in-service. Is this a valid criticism?

A. Staff thinks not. The only real "remedy" to Mr. Jenkin's complaint is to implement a rate recovery system that quantifies and includes in rates all of the ongoing financial results of the utility as they occur, which is obviously impossible. Staff would note that it is certainly possible for utilities to add plant in service for which no direct concurrent recovery is reflected in rates even under a future test year construct.

Q. At page 29 – 30 of his rebuttal testimony, Mr. Jenkins criticizes Staff's suggestion that productivity assumptions should be incorporated into any future test year ratemaking scenario, calling it "artificial productivity imputation." Please comment.

A. Mr. Jenkins might be on stronger ground if MAWC was not proposing that certain of its expenses be escalated using general inflation factors. For the reasons stated in Staff's Cost of Service Report, Staff views that proposal as constituting an "artificial inflation imputation." If assumptions regarding inflation are properly considered in setting rates, then assumptions regarding offsetting productivity impacts should be considered as well.

Q. At page 30, lines 16 -19, Mr. Jenkins opposes Staff's suggestion that additional surveillance information, in the form of budget variance analyses, be provided if a future test year is adopted. Is Mr. Jenkins' response reasonable?

A. No. As explained in length is Staff's previous filings in this case, adoption of a future test year approach in this jurisdiction would be a major and far-reaching change. Current utility surveillance reporting in Missouri was developed solely in the context of historical test year ratemaking. It is not reasonable to reject out of hand possible modifications to utility periodic surveillance reporting in the event future test years are authorized in Missouri.

TAX CUTS AND JOBS ACT

Q. Please summarize MAWC's proposals for incorporating the TCJA in customer rates resulting from this case.

A. In Mr. Jenkins' rebuttal testimony, he suggests the financial impacts of the TCJA can be reflected in customer rates in this rate case and future rate proceedings in three different ways.

First, he proposes that the impacts of the TCJA for the period of January through May 2018 (prior to when new rates will go into effect from this case) be deferred through what Mr. Jenkins calls the "stub period AAO" and amortized into rates in this case. However, MAWC states its acceptance of such treatment is conditioned upon approval of a concurrent deferral of certain property taxes that was sought by MAWC in Case No. WU-2017-0351. Second, MAWC proposes that the financial impact of flow back of excess accumulated deferred taxes to customers brought about by the TCJA should be deferred in lieu of immediate rate reflection in rates, as information is currently lacking regarding the mechanics of the excess deferred tax flow back. Mr. Jenkins refers to this proposal as the "ADIT Remeasurement AAO." Finally, MAWC is proposing an approximate $20 million reduction in its recommended revenue requirement in this case, to reflect the reduction in the federal corporate tax rate.

Q. What is Staff's position regarding MAWC's proposed stub period AAO?

A. Staff does not support this proposal. Because MAWC's existing rate case is a potential vehicle for relatively fast reflection of TCJA benefits in customer rates, Staff's position is that a deferral of TCJA financial effects back to January 1, 2018 is not necessary if the revenue requirement in this case reflects the impact of the federal corporate income tax rate reduction.

Q. In the event that the Commission is interested in the concept behind the stub period AAO proposal, should it consider offsetting that deferral with another deferral relating to property taxes?

A. No. The Commission ruled against MAWC on this issue in its *Report and Order* in Case No. WU-2017-0351, and recently denied rehearing of that decision. Given this history, there is no property tax deferral to offset against an income tax rate change deferral.

Q. What is Staff's position regarding the ADIT remeasurement AAO?

A. Staff's position is generally that any financial impact of the TCJA that cannot be accurately measured in the context of a current rate case should be deferred and considered for rate recovery in subsequent rate cases. However, Staff is not convinced at this point that all or some part of the excess ADIT flow back will not be reasonably known and measurable within the timeframe of this case, and thus eligible for current rate recognition in this case. Staff will continue to examine this question, and present its final position on potential deferral of excess ADIT flow back no later than in the true-up phase of this case.

Q. Finally, what is Staff's position regarding a reduction to MAWC's revenue requirement in this case on account of the TCJA lower corporate income tax rates?

A. Staff supports recognition of the impact of the lower income tax rates in this case. However, Staff disagrees with MAWC's quantification of this impact.

Q. What is Staff's disagreement with the quantification of an approximate $20 million reduction to MAWC's revenue requirement from lowering of the corporate tax rates?

A. MAWC quantified this impact using its projected revenues, expenses and rate base amounts within its future test year. Consistent with how Staff's has structured its revenue requirement recommendation in this case, Staff recommends that quantification of this revenue requirement reduction be based upon actual MAWC financial results through year-end 2017. Further, Staff continues its general review of the TCJA in Docket No. AW-2018-00174, with a report due no later than February 15, 2018. As the actual MAWC financial results are not yet available to Staff, and Staff has not completed its general review of the TCJA, Staff's quantification of the rate impact will be presented as part of our true-up testimony filings later in this case.

Q. Does Staff have an estimate of what this particular TCJA impact might be worth?

A. Yes. Based upon its current revenue requirement recommendation measured through June 30, 2017, Staff estimates the impact of the lowering of the federal corporate tax rate may be worth approximately $ 16 million. The ultimate ratemaking quantification of the federal corporate tax rate reduction is dependent upon the Commission decisions in this rate case on all other components of MAWC's cost of service.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Request for Authority to Implement General Rate Increase for Water and Sewer Service Provided in Missouri Service Areas	)))))	Case No. WR-2017-0285

AFFIDAVIT OF MARK L. OLIGSCHLAEGER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW MARK L. OLIGSCHLAEGER and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing Surrebuttal Testimony; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

Mark L. Oligschlaeger

MARK L. OLIGSCHLAEGER

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 8th day of February, 2018.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2020
Commission Number: 12412070

D Suzie Mankin

Notary Public