

Exhibit No.: _____
Issue(s): Net Operating Loss (NOL)
Witness/Type of Exhibit: Riley/Direct
Sponsoring Party: Public Counsel
Case No.: WR-2020-0344

DIRECT TESTIMONY

OF

JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2020-0344

November 24, 2020

DIRECT TESTIMONY

OF

JOHN S RILEY

CASE NO. WR-2020-0344

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

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

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

4 A. I am employed by the Missouri Office of the Public Counsel (“OPC”) as a Senior Utility
5 Auditor.

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

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

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

10 A. I was employed by the OPC from 1987 to 1990 as a Public Utility Accountant. In this capacity,
11 I participated in rate cases and other regulatory proceedings before the Public Service
12 Commission (“Commission”). From 1994 to 2000 I was employed as an auditor with the
13 Missouri Department of Revenue. I was employed as an Accounting Specialist with the
14 Office of the State Court Administrator until 2013. In 2013, I accepted a position as the Court
15 Administrator for the 19th Judicial Circuit until April 2016 when I joined the OPC as a Public
16 Utility Accountant III. I have also prepared income tax returns, at a local accounting firm, for
17 individuals and small business from 2014 through 2017

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

19 A. Yes. As a CPA, I am required to continue my professional training by attending Missouri
20 State Board of Accountancy qualified educational seminars and classes. The State Board of
21 Accountancy requires that I spend a minimum of 40 hours a year in training that continues

1 my education in the field of accountancy. I am also a member of the Institute of Internal
2 Auditors (“IIA”) which provides its members with seminars and literature that assist CPAs
3 with their annual educational requirements.

4 **Q. Have you previously filed testimony before the Missouri Public Service Commission?**

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

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

7 A. The purpose of my testimony is to address the treatment that the Commission should afford
8 the “net operating losses” (“NOL”) reflected on Missouri American Water Company’s
9 (“MAWC”) books. It is my conclusion that MAWC’s inclusion of an NOL in its calculations
10 of rate base and revenue requirement for this case is inappropriate due to the income tax
11 expense built into the case as well as a misapplication of the Internal Revenue Service (“IRS”)
12 normalization rules.

13 **Q. What is the adjustment you are proposing?**

14 A. Company answer to OPC data request 1302, attached as JSR-D-2, indicates the NOL amount
15 included in its revenue requirement is \$43.8 million for federal taxes and \$7.2 million for state
16 taxes. Of these totals, the Company identified \$24.7 million as protected and \$26.3 million
17 as unprotected. Because of several factors, I am recommending a total reduction of \$51
18 million from the Company’s \$407 million baseline rate base.

19 **Q. Would you please summarize MAWC’s argument as to how the NOL affects these
20 calculations?**

21 A. Under established rate making procedures, a company’s rate base is reduced by the deferred
22 tax balance (“ADIT”) that has accumulated due to the difference between the regulatory
23 depreciation balance used in ratemaking and the larger depreciation balance created by the
24 use of accelerated depreciation methods employed for tax purposes. The ADIT balance is the

1 difference between the regulatory depreciation and the accelerated depreciation multiplied by
2 the federal/state tax rate. MAWC is arguing that the NOL created by accelerated depreciation
3 and other IRS tax advantage allowances should be applied as an offset to this ADIT rate base
4 reduction.

5 As an example, let's assume a simplified rate base of \$100, an ADIT of \$5, and an NOL of
6 \$1. The normal calculation is to reduce the \$100 rate base by the \$5 of ADIT yielding a final
7 rate base of \$95 ($\$100 - \$5 = \95). The Company asserts that the NOL of \$1 should reduce
8 the ADIT so its calculation is the \$100 rate base less the \$4 that results from reducing the \$5
9 ADIT by the \$1 NOL for a total final rate base of \$96 ($\$100 - (\$5 - \$1) = \96).

10 **Q. Why is MAWC's position regarding the application of an NOL in this manner**
11 **incorrect?**

12 A. ADIT is a tax benefit conferred on a utility by the federal government. It effectively functions
13 as a form of interest free loan represented by the money the utility collects from ratepayers –
14 ostensibly so it can pay income taxes – but then it does not actually remit as taxes.¹ MAWC
15 is attempting to convince the Commission that its NOL, which is merely a tax return item
16 used to reduce tax liability, somehow prevents the Company from making use of this interest
17 free money. This is obviously false.

18 ADIT is already incorporated into the income tax expense that is itself included in MAWC's
19 revenue requirement. The Company will consequently collect and have access to this interest
20 free money regardless of any NOL it claims on its books. Moreover, it is inappropriate to try
21 and offset ADIT with an NOL without taking into consideration the rest of MAWC's income
22 tax expenses that should otherwise offset the NOL.

¹ Does not remit as tax until the timing difference reverses.

1 **Q. What are you referring to when you mention “the rest of MAWC’s income tax**
2 **expenses?”**

3 A. ADIT only makes up a part of MAWC’s total income tax expense to be included in MAWC’s
4 revenue requirement. The remaining income tax expense, which Staff refers to as the “current
5 income tax expense” can be thought of as the income tax the utility will still be expected to
6 remit to the IRS even though it is using accelerated depreciation instead of straight line
7 depreciation. However, even though this remaining income tax expense is included in
8 MAWC’s revenue requirement, it still does not end up being paid as taxes.

9 **Q. How can it be that this remaining income tax expense is not being used to pay MAWC’s**
10 **income taxes?**

11 A. MAWC does not pay current income taxes despite collecting income tax expenses from
12 customers precisely because of the NOL that the Company is now relying on for its
13 argument to reduce ADIT. This NOL is effectively used by MAWC to reduce its tax
14 liability to zero and, as a result, MAWC has not paid a dime in federal taxes in over three
15 years. This means that the current income tax expense included in MAWC’s revenue
16 requirement is effectively also a source of interest free money for the Company.

17 **Q. So your basic argument is that the Company enjoys interest free money over and**
18 **above the ADIT portion of its income tax expense due to the remaining portion of**
19 **income tax expense that is not paid to the taxing authorities?**

20 A. Yes. Any NOL offset MAWC might claim would be completely negated by the current
21 income tax portion of the income tax expense built into rates that exists independently of
22 ADIT.

1 **Q. What amount did Staff include as the current portion of income tax expense in the**
2 **last general rate case for MAWC?**

3 **A.** For WR-2017-0285, Staff's initial accounting schedules included a current portion of
4 income tax expense of \$21,681,560. So when that case was finalized, MAWC had the use
5 of a similar amount each year. That is over \$60 million in interest free money over three
6 years. That is more than enough to offset the \$53 million that the Company proposes to
7 include as a reduction to ADIT.

8 **Q. What would be the result of allowing MAWC to reduce its ADIT by the claimed NOL**
9 **without considering the remaining income tax expense?**

10 **A.** Right now, MAWC's revenue requirement will include income tax expense calculated as
11 though MAWC were using straight-line depreciation method. When MAWC actually goes
12 to remit its taxes to the IRS, however, it will calculate those taxes as though it were using
13 accelerated depreciation thus leaving a sizable amount of the money that MAWC collected
14 from ratepayers to cover its tax expenses in MAWC's possession. That amount of money
15 represents the ADIT. At the same time, MAWC will employ its NOL to reduce the
16 remaining portion of its tax liability to zero. Thus, MAWC will effectively retain all of the
17 income expense included in rates for its own use. Because the NOL is already going to be
18 used to reduce MAWC's remaining income tax liability to zero, allowing MAWC to also
19 reduce the ADIT portion of its income tax expense by the same amount would effectively
20 be double dipping. This should not be allowed.

21 **Q. In addition to arguing that MAWC's NOL adjustment was inappropriate due to the**
22 **income tax expense built into the case, you had also mentioned in your opening**
23 **statement that including the NOL was a misapplication of the normalization rule.**
24 **Could you explain that statement?**

25 **A.** Yes. The IRS normalization rules only apply to items subject to accelerated depreciation.
26 Expense items that are depreciated in ratemaking but are written off immediately for tax

1 purposes are not required to be normalized. Company indicated in JSR-D-2 that \$26.3
2 million of the proposed NOL deduction was attributable to unprotected (nonaccelerated
3 depreciation items). Not recognizing this portion of the proposed NOL is not a violation
4 of IRS rules.

5 I point this out due to the fact that MAWC has argued the presence of normalization
6 violations in its last four ISRS cases. This argument does not apply to this unprotected
7 NOL amount.

8 **Q. Could you summarize your argument for excluding the NOL adjustment from rate**
9 **base?**

10 A. Yes. MAWC has argued in the past that the NOL must be recognized due to the
11 Company's inability to utilize the interest free money created by the ADIT. This is wrong.
12 The unspent income tax expense already included in MAWC's revenue requirement is
13 more than enough interest free money to offset any NOL on the Company's books.

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

15 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
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
MISSOURI AMERICAN WATER COMPANY	CASE NO. WO-2018-0373
LIBERTY UTILITIES EMPIRE ELECTRIC CO	CASE NO. EA-2019-0010
SUMMIT NATURAL GAS OF MISSOURI, INC	CASE NO. GR-2018-0230
SPIRE NATURAL GAS, EAST/WEST ISRS	CASE NO. GO-2019-0115
MISSOURI AMERICAN WATER COMPANY	CASE NO. WO-2019-0184

John S. Riley, CPA
Summary of Case Participation

AMEREN GAS	CASE NO. GR-2019-0077
UNION ELECTRIC COMPANY	CASE NO. ER-2019-0335
LIBERTY EMPIRE ELECTRIC CO.	CASE NO. ER-2019-0374
MISSOURI AMERICAN WATER CO.	CASE NO. WO-2020-0190
EMPIRE ELECTRIC COMPANY FAC	CASE NO. ER-2020-0311

DATA INFORMATION REQUEST
Missouri-American Water Company
WR-2020-0344

Requested From: Brian LaGrand
Date Requested: 8/26/2020

Information Requested:

NOL in rate base - Please provide the NOL balances that Company proposes to include in rate base for this case. Please break-out NOL by protected and unprotected balances. Also separate NOL into actual and future test year balances.

Requested By: John Riley - Office of Public Counsel – john.riley@opc.mo.gov

Information Provided:

The following table provides the gross NOLC outstanding as of 12/31/2019 used for year end tax provision purposes, which will be updated in a later filing when the tax return is completed. 2020 activity and balances will be provided in as scheduled to be updated.

A NOL DTA was not originally included in the ADIT balance used to computed rate base for this case, as it was prepared assumed the Company would be using a future test year in which the Company did not expect to be carrying an NOLC. Given a historic test year of 2019 updated for 2020 is now being used, it would be appropriate economically and pursuant to the tax normalization rules to include the NOLC DTA carried by the Company during the test year.

EADIT remains a component of ADIT included in rate base until normalized/amortized.

For the purpose of responding to this data request the Company used the with and without method to determine which portion of the of the NOLC balance is protected and which portion of the NOLC balance was unprotected. The DTA related to the Federal NOLC for historical test year of 12/31/2019 is \$20.9M of ADIT and \$22.8M of EADIT, of that \$24.7M is protected and \$19.1M is unprotected. The State NOL DTA is \$7.2M, which is all unprotected.

	<u>Gross</u>	<u>ADIT</u>	<u>EADIT</u>	Total Regulatory ADIT
Federal NOL	99,969,600	20,993,616	22,817,238	43,810,854
	<u>Protected</u>			
	68,746,758	14,436,819	10,293,171	24,729,990
	<u>Unprotected</u>			
	31,222,842	6,556,797	12,524,067	19,080,864
State NOL	<u>Unprotected</u>			
		2,069,616	5,166,647	7,236,263

Responsible Witness: John Wilde