Exhibit No.:	______________
Issue(s):	Net Operating Loss (NOL)
Witness/Type of Exhibit:	Riley/Rebuttal
Sponsoring Party:	Public Counsel
Case No.:	WO-2019-0184

REBUTTAL TESTIMONY

OF

JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WO-2019-0184

May 13, 2019

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Petition of	)	
Missouri-American Water Company	)	
for Approval to Change an	)	File No. WO-2019-0184
Infrastructure System Replacement	)	
Surcharge (ISRS)	)	

AFFIDAVIT OF JOHN S. RILEY

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

Subscribed and sworn to me this 13th day of May 2019.

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI
JERENE A. BUCKMAN
My Commission Expires
August 23, 2021
Cole County
Commission #13754037

Jerene A. Buckman
Jerene A. Buckman
Notary Public

My Commission expires August 23, 2021.

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OF

JOHN S. RILEY

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WO-2019-0184

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. Are you the same John S. Riley that filed direct testimony in this case?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my testimony is to refute Missouri American Water Company ("MAWC" or "Company") witness John R. Wilde's assertions in his direct testimony regarding the proposed inclusion of the Company's hypothetical net operating loss ("NOL") in MAWC's Infrastructure System Replacement Surcharge ("ISRS") calculations. I explain that the company did not generate any NOL during the ISRS timeframe of October 1, 2018 through March 31, 2019. I also discuss the fact that the Commission's exclusion of an NOL in this case does **not** deny the company the benefit of using the interest free accumulated deferred income tax ("ADIT"). Further, I explain that excluding an NOL does not violate the Internal Revenue Service ("IRS") normalization rules.

LACK OF NOL DURING ISRS PERIOD

Q. Was MAWC in an income tax loss situation during the October 1, 2018 through March 31, 2019 ISRS period?

A. No, they were not. Rarely does a regulated utility have an actual financial loss and as I explain below MAWC is certainly not in that situation here.

Q. How do you know?

A. There is a simple explanation. An income tax loss, otherwise referred to as an NOL, is an **income tax return generated event**. An income tax reportable loss occurs when a corporation's consolidated tax deductions surpasses the taxable income included on its annual income tax return. American Water Works ("AWW") can only claim an NOL upon completion and filing of its consolidated federal or state income tax return. On behalf of the consolidated companies, AWW will file its 2018 federal income tax return in September 2019. Until that time, AWW has not reported any income tax generated event. Stated another way, AWW has not filed with the IRS a return that shows any income or expenses that correspond to the ISRS timeframe at issue, meaning that MAWC cannot demonstrate an NOL occurred during this period.

Q. Do you agree with MAWC's argument that an NOL should be included in the ISRS calculations?

A. No. Mr. Wilde contends that MAWC's NOL carryover balance from **prior periods** should be factored into the ISRS-eligible investment.

Q. How do you respond to this argument?

A. An ISRS proceeding is a statutorily authorized, single issue, time specific, ratemaking. Staff calculates all of the costs then calculates the company's ROE on specific ISRS eligible infrastructure constructed within a specific timeframe. For Mr. Wilde to argue that a prior period NOL balance should be included in the calculations presents several inconsistencies with established regulatory and accounting principles.

Q. What principles would be violated?

A. The matching principle would be the first violation that comes to mind. NOLs are not asset specific. NOLs are, instead, an accumulation of tax deductions filed on a tax return, so to point at a specific ISRS-eligible asset, which notably, has a **profit** calculation built into the total, and to say there should be a loss attached to the total is a mismatching of values.

The cost principle would be another violation. An NOL has no cost attached to it. No money was expended to produce an NOL. In the nonregulated business sector, an NOL is recorded as an asset on the balance sheet because it has value. The value is that the NOL can actually be applied to taxable income, to reduce future income taxes payable. In that respect, recording an NOL recognizes a future savings in tax costs. In contrast, regulated utilities' customers are paying income tax expense in rates. Not only are deferred income taxes built into rates, but income tax expense for Commission authorized profits are also built into consumers' rates.

<u>EXCLUSION OF AN NOL DOES NOT REDUCE INTEREST FREE MONEY</u>

Mr. Wilde has stated in his direct testimony in the prior case, WO-2018-0373 and the current case:

> The intent of Congress in creating the normalization rules, is to provide the utility an interest free source of funds to invest in utility property. To the extent that the utility does not receive this interest free source of funds because taking the accelerated depreciation deduction causes a taxable loss, that taxable loss needs to be included in the numbers so that the customers are not benefiting before the utility company receives the benefits.[1]

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[1] Wilde direct testimony, WO-2018-0373, page 6, lines 3-9; WO-2019-0184, page 5, lines 19-24

Q. How do you respond to this quote?

A. Mr. Wilde has implied that the ratepayer would prematurely benefit from reduced rate base if the NOL is not recognized. This is a misstatement of fact. The exclusion of an NOL in no way impedes the company's use of interest free funds and the ratepayer does not receive any premature benefit from this action.

An example may be helpful to illustrate how deferred taxes (interest free funds) are accumulated and normalized. Schedule JSR-R-1 provides a simple illustration that demonstrates the accumulation of deferred tax and also how it is normalized through regulatory processes.

Q. Will you provide a narrative to help with the example?

A. Yes. The parameters are straightforward. There is one $ 100,000 plant asset (rate base) placed into service, which has a useful life of 10 years. Actual net income is not important to show how ADIT is calculated correctly, however, $100,000 net income will be used to help visualize the income tax accounting entries for years 1-5 and 6-10.

Regulatory depreciation is $10,000 annually ($100,000/10), while in contrast, for <u>tax purposes</u> accelerated depreciation is $20,000 a year for five years. In the illustration, the accelerated depreciation for taxes creates a difference of $2,100 in taxes payable ($16,800) in contrast to the income tax expense allowed in rates ($18,900). This difference is a benefit to the utility because the Commission considers this ADIT to be interest-free money the Company may use. Accordingly, the Commission reduces rate base by this amount to reflect the Company's benefit of interest free use of this depreciation difference. This difference will occur in each of the first five years until the accelerated depreciation is exhausted and the plant has a zero value for tax purposes. The annual $2,100 difference in taxes accumulates (ADIT) each year for the first five years, totaling $10,500.

Schedule JSR-R-1 presents a simple yet accurate description of the normalization accounting established by IRS regulations. The IRS Normalization method of accounting requires that a reserve account[2] be established to record this difference in tax expense/payable created by the use of different depreciation methods for rates and taxes.

Q. What happens to the ADIT balance in your illustration after year five?

A. The tax benefit reverses and flows back through the ADIT account for the remaining regulatory life of the asset. This is the essence of the normalization principle - benefits build up with accelerated depreciation and reverse over the asset's remaining life when the accelerated depreciation expires. The key point that is not readily apparent in the IRS regulation or in my example, is that the accumulation of deferred tax or the gradual return of that tax after-year-five, is not adjusted by the utility's net income. So if income does not alter the flow of ADIT the Company cannot claim it is denied full use of the interest free money by having an NOL.

Q. If net income is not a factor then how is deferred tax calculated and normalized?

A. Deferred tax is calculated on the *difference* between using accelerated depreciation for taxes and the straight-line depreciation for regulatory purposes. The quotation below from *IRS section 168* contains no reference to income in the calculation of regulated tax expense. Instead, it requires the utility (taxpayer) to adjust a reserve to show the deferral of taxes resulting from accelerated depreciation and straight-line depreciation:

> if the amount allowable as a deduction under this section with respect to such property (respecting all elections made by the taxpayer under this section) differs from the amount that would be allowable as a deduction under section 167 using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under clause (i), the taxpayer must make

[2] The actual USOA account would be the liability account, 281 Accumulated Deferred Income Taxes, but the account is not important for this demonstration.

> adjustments to a reserve to reflect the deferral of taxes resulting from such difference.[3]

To state it differently, there is no discussion of income in this paragraph, whether that income is negative or positive. Referring back to my example in JSR-R-1, income tax expense that is built into MAWC rates is developed using straight line depreciation. To take that a step further, for the most part, the income tax expense is developed using straight financial accounting whereas AWW can benefit from many tax exclusions that will lower its taxable income. So MAWC receives the tax expense in rates whether the company owes income tax or has an NOL. It is almost like a second deferred tax account.

Q. How could this be viewed as a "second deferred tax account"?

A. Income tax expense is calculated and built into rates as if MAWC is making a given amount of profit. On one hand the Company receives interest free money (deferred tax expense from accelerated depreciation) and also receives income tax expense for the allowed profit by the Commission, yet AWW does not spend it on taxes because of the taxable loss. To also have the Commission recognize an NOL as a reduction in ADIT would amount to a double recovery.

Q. How would that be double dipping?

A. The Company states that ADIT should be adjusted downward because it cannot use an NOL. The double dipping is that: (1) the company did not pay any taxes (NOL) yet it recovered the income tax expense in rates and then (2) the Company wants ADIT reduced for something it was compensated for in rates.

[3] § 168(i)(9)(ii) CFR?

Q. Can you summarize why the NOL should be excluded?

A. The point I'm making is that there was no NOL during the ISRS time period and, even if there were, the Company cannot assign it to the ISRS calculations because an NOL is not asset specific.[4] The company argument that excluding the NOL denies it the use of interest free money is wrong due to the normalization of the ADIT flow back <u>over the life of the asset</u> regardless of taxable income or loss. The accumulation or dispersion of ADIT is a timing issue, where as an NOL can be created in one tax year and be used with the next taxable income. An NOL is not normalized and does not influence Staff's calculation of income tax expense.

Q. Does this conclude your rebuttal testimony?

A. Yes.

[4] *See* Case No. WO-2018-0373 At hearing Mr. Wilde was asked the direct question, "An NOL is not attached to any certain infrastructure, any particular asset?" Mr. Wilde answered: You're correct with that." Tr. Vol. 1, 52:16-18.

Example of the Normalization of Deferred Income Tax

10 year regulatory life with 5 year tax depreciation

$ 100,000.00 Addition to Rate Base

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Depreciation for taxes	20,000.00	20,000.00	20,000.00	20,000.00	20,000.00	0	0	0	0	0
Tax Rate	21%	21%	21%	21%	21%	21%	21%	21%	21%	21%
Deduction in Taxes	4,200.00	4,200.00	4,200.00	4,200.00	4,200.00	0	0	0	0	0
Depreciation for Rates	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00
Tax Rate	21%	21%	21%	21%	21%	21%	21%	21%	21%	21%
Deduction for Rates	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00
	Tax Income	Reg Income				Reg Income	Tax Income			
Hypothetical income	100,000.00	100,000.00				100,000.00	100,000.00			
tax deduction	20,000.00	10,000.00				(10,000.00)	-			
taxable income	80,000.00	90,000.00				90,000.00	100,000.00			
	21%	21%				21%	21%			
income tax	16,800.00	18,900.00	(2,100.00)			18,900.00	21,000.00	2,100.00		

	Yr 1-5					Yr 6-10				
Income Tax Expense	**18,900.00**					**18,900.00**				
income tax payable		**16800**					**21000**			
Deferred Income Tax		**2100**				**2100**				

The Accumulation and Reduction of Deferred Income Tax - Normalization Accounting

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Accumulating Deferred Tax		2,100.00	4,200.00	6,300.00	8,400.00	10,500.00	8,400.00	6,300.00	4,200.00	2,100.00
Annual Add/Reduction	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	(2,100.00)	(2,100.00)	(2,100.00)	(2,100.00)	(2,100.00)
Rate Base Deduction	2,100.00	4,200.00	6,300.00	8,400.00	10,500.00	8,400.00	6,300.00	4,200.00	2,100.00	-