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 Infrastructure System Replacement Surcharge (ISRS)	)))	**File No. WO-2020-0190** Tariff No. YW-2020-0148

STAFF RECOMMENDATION

COMES NOW the Staff of the Missouri Public Service Commission ("Staff"), by and through counsel, and states as follows:

1. On March 2, 2020, Missouri-American Water Company ("MAWC" or "Company") filed its *Petition to Change Its Infrastructure System Replacement Surcharge & Motion for Approval of Customer Notice* ("*Petition"*).

2. MAWC's *Petition* requests an adjustment to its ISRS rates and charges for ISRS-eligible infrastructure systems replacements and relocations made during the period of October 1, 2019, through March 31, 2020.

3. On March 3, 2020, the Commission set a deadline for intervention of March 30, 2020 (the March 3rd Order). No parties intervened.

4. The March 3rd Order also directed Staff to file a recommendation on MAWC's *Petition*.

5. Commission Rule 20 CSR 4240-3.650(11) states that the staff of the Commission may examine information of a water utility to confirm the underlying costs related to the proposed ISRS and to confirm proper calculation of the proposed charge.

6. Based on its examination and calculations as detailed in its attached Memorandum, Staff recommends the Commission approve incremental ISRS surcharge revenues in the amount of $9,725,687.

Net Operating Losses

7. As explained in its *Petition*, MAWC's last three ISRS cases (Case Nos. WO-2018-0373, WO-2019-0184, and WO-2019-0389) concerned an issue related to a potential tax normalization violation. In each of these matters, the Commission excluded amounts relating to hypothetical net operating losses ("NOLs"); amounts whose inclusion MAWC contended was necessary to comply with Internal Revenue Service ("IRS") normalization rules. In June 2019, MAWC made a request for a Private Letter Ruling ("PLR") from the IRS to obtain guidance on the proper treatment of net operating losses within an ISRS. Prior to the issuance of an IRS ruling on MAWC's PLR request, in its most recent ISRS filing (Case No. WO-2019-0389), Staff and MAWC entered into a *Partial Stipulation and Agreement*,[1] in which Staff agreed to support an application from MAWC for an Accounting Authority Order ("AAO") to permit MAWC to record a regulatory asset capturing the rate differential in an amount as may be necessary to cure a normalization violation identified by the PLR issued by the IRS. The IRS issued a ruling in response to MAWC's PLR request on December 3, 2019; that ruling was attached as Confidential Appendix M to MAWC's *Petition*.

8. Staff has reviewed the PLR for its potential impact on this proceeding, and through its analysis concludes that within the PLR the IRS determined that the Commission's actions in reflecting a full deduction of applicable accelerated depreciation amounts without offset for an NOL amount in ISRS *did* constitute a violation of the IRS Code's normalization restrictions. However, the IRS also ruled that the Commission's treatment of reflecting a full deduction of applicable repair allowance amounts did not violate the normalization restrictions within the Code.

[1] While the stipulation and agreement was entered into by MAWC and Staff, as no party filed an objection to it, the Commission chose to consider it as unanimous, pursuant to Commission Rule 20 CSR 4240-2.115, and approved the agreement in its November 21, 2019, *Order Approving Partial Stipulation and Agreement and Approving Infrastructure System Replacement Surcharge*, issued in Case No. WO-2019-0389.

9. In its *Petition*, MAWC proposes the ISRS be adjusted in this proceeding to cure normalization violations resulting from its last three ISRS cases, rather than deferring the amounts through an AAO as contemplated in the *Partial Stipulation and Agreement* approved by the Commission in Case No. WO-2019-0389. To accomplish this, MAWC proposes an adjustment to appropriate pretax revenues to be recovered in its ISRS of approximately $35,000. As more thoroughly explained in the attached Memorandum, after reviewing MAWC's *Petition* and the attached PLR, Staff agrees with MAWC's calculation of its proposed adjustment, and does not oppose MAWC's proposal to address these amounts in this proceeding. MAWC's current ISRS was established in Case No. WO-2018-0373. Thus, Staff views MAWC's proposed adjustment as a proper recognition of accumulated deferred income taxes associated with eligible infrastructure system replacements included in MAWC's currently effective ISRS, necessary to calculate appropriate pretax revenues.[2]

WHEREFORE, Staff recommends the Commission issue an Order in this case that (1) rejects MAWC's ISRS tariff sheet (YW-2020-0148) P.S.C MO No. 13 13th Revised Sheet No. RT 10 cancelling 12th Revised Sheet No. RT 10 filed on March 2, 2020; (2) approves Staff's recommended ISRS surcharge revenues in this docket in the incremental pre-tax revenue amount of $9,725,687, and; (3) relieves MAWC from the terms of the *Partial Stipulation and Agreement* approved by the Commission in Case No. WO-2019-0389.

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[2] Section 393.1000.1, RSMo, defines "Appropriate pretax revenues" as: the revenues necessary to produce net operating income equal to:

(a) The water corporation's weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system replacements which are included in a currently effective ISRS; and
(b) Recover state, federal, and local income or excise taxes applicable to such income; and
(c) Recover all other ISRS costs.

Respectfully submitted,

/s/ Mark Johnson

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Attorney for the Staff of the
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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile, or electronically mailed to all parties and/or counsel of record on this 1st day of May, 2020.

/s/ Mark Johnson

MEMORANDUM

TO: Missouri Public Service Commission Official Case File Case No. WO-2020-0190, Tariff No. YW-2020-0148 - Missouri-American Water Company

FROM: Amanda McMellen, Utility Regulatory Auditor V, Auditing Department
Ali Arabian, Utility Regulatory Auditor II, Auditing Department
Matthew J. Barnes, Utility Regulatory Auditor IV, Water and Sewer Department

/s/ Kim Bolin 05/01/2020
Auditing Department / Date

/s/ James Busch 05/01/2020
Water and Sewer Department / Date

/s/ Mark Johnson 05/01/2020
Staff Counsel's Office Date

SUBJECT: Staff Report and Recommendation Regarding the Petition of Missouri American Water Company for Approval to Change its Infrastructure System Replacement Surcharge ("ISRS")

DATE: May 1, 2020

BACKGROUND

On March 2, 2020, Missouri-American Water Company ("Company" or "MAWC") filed its *Petition for Approval to Change its Infrastructure System Replacement Surcharge* ("Petition") with the Missouri Public Service Commission ("Commission"). The Company submitted its Petition pursuant to the provisions of Sections 393.1000, 393.1003, 393.1006, RSMo 2016, and Commission rules 20 CSR 4240-2.060(1) and 3.650. These sections provide eligible water corporations with the ability to recover certain infrastructure system replacement costs without the need to file a formal rate case. Instead, these investments in infrastructure are recovered through an Infrastructure System Replacement Surcharge ("ISRS"). Since the Company's most recent general rate case, Case No. WR-2017-0285, MAWC has completed three ISRS cases, Case Nos. WO-2018-0373, WO-2019-0184, and WO-2019-0389.

In the current case, MAWC submitted its Petition to reflect ISRS investment that had been placed into service for the period October 1, 2019, to January 31, 2020, with estimated ISRS costs through March 31, 2020, also included. MAWC estimated in its Petition that it was entitled to an incremental increase of ISRS revenues in this case of $8,996,922, or an increase of 4.4% based on the base revenue level approved by the Commission in its most recent rate case.

On March 3, 2020, the Commission issued its *Order Directing Notice, Setting Intervention Deadline, Directing Filing, and Suspending Tariff* establishing March 30, 2020, as the deadline to intervene in the instant case. The Commission directed Staff to file a report regarding its examination of the ISRS filing no later than May 1, 2020.

STAFF INVESTIGATION

Commission rule 20 CSR 4240-3.650(2) states, "an eligible water utility may file a petition with the commission to establish or change ISRS rate schedules that will allow for the adjustment of its rates and charges to provide for the recovery of costs eligible for infrastructure system replacements; provided that an ISRS, on an annualized basis, must produce ISRS revenues of at least one (1) million dollars, but not in excess of ten percent (10%) of the subject utility's base revenue level approved by the Commission in the utility's most recent general rate proceeding." This filing meets the criteria of at least one (1) million dollars and does not exceed ten percent of the base revenue levels of $318 million approved by the Commission in the most recent MAWC general rate case, Case No. WR-2017-0285.

In its Petition, MAWC filed to recover ISRS qualifying infrastructure replacement costs incurred during the period of October 1, 2019, through January 31, 2020. In its initial filing, MAWC estimated data for February 2020 and March 2020 plant investment for its request. MAWC provided supporting documentation for the investments made in October 2019 through January 2020 in response to Staff Data Request No. 2 on March 25, 2020. MAWC subsequently provided Staff with additional documentation to support additions placed into service in February through March 2020, with the final batch of supporting documentation received April 16, 2020.

As part of its examination of MAWC's Petition, Auditing Staff reviewed supporting workpapers, descriptions of ISRS projects, MAWC's accounting entries, and a sample of invoices representing approximately 66.67% of total ISRS investment costs, as well as other applicable documentation, such as work order authorizations. Staff communicated with MAWC personnel to clarify MAWC's Petition when necessary.

THE PETITION

As stated in its Petition, MAWC "seeks to change its ISRS rate to provide for the recovery of costs for infrastructure system replacements and relocations eligible for ISRS recognition. The proposed ISRS rate schedule should reflect the appropriate pre-tax ISRS revenues necessary to produce net operating income equal to MAWC's weighted cost of capital multiplied by the net original cost of the requested infrastructure replacements that are eligible for the ISRS, including recognition of net accumulated deferred income taxes and accumulated depreciation associated with the aforesaid infrastructure system replacements. MAWC also seeks to recover all state, federal and local income or excise taxes applicable to such ISRS income and to recover all other ISRS costs such as depreciation expense and property taxes due within 12 months of this filing."

In its Petition, MAWC indicates that all of the eligible infrastructure system requirements meet the following criteria:

1. They replace and/or extend the useful life of existing infrastructure;
2. They are currently in service and used and useful;
3. They do not increase revenues by directly connecting to new customers since all ISRS projects represented replacements of existing facilities or relocations of existing facilities;
4. They were not included in MAWC's rate base in its most recently completed general rate case, Case No. WR-2017-0285;
5. The costs related to such projects have not been reimbursed to the utility; and
6. They were not included in any other MAWC ISRS filing.

MAWC also indicates that the water utility plant projects on which it seeks to base the ISRS are either:

1. Mains and associated valves and hydrants installed as replacements for existing facilities that have worn out or were in a deteriorated condition; or
2. Main cleaning and/or relining projects; or
3. Infrastructure facility relocations due to the construction or improvement of a highway, road, street, public way, or other public work required by or on behalf of the United States, the State of Missouri, a political subdivision of the State of Missouri, or another entity having the power of eminent domain.

Reimbursements that MAWC has subsequently received for these projects have been recognized as a reduction of the ISRS investment in the calculation of the ISRS revenue requirement.

The Company's Petition indicates that its proposed rate schedule (including some estimates) will "produce ISRS revenues of $8,996,922, or an increase of 4.4% based on the base revenue level approved by the Commission in its most recently completed general rate proceeding" on an annualized basis.

STAFF'S REVENUE CALCULATION

With one exception, Staff agrees with the methodology and amounts utilized by MAWC in the calculation of the ISRS revenue requirement for the purpose of this ISRS filing. The one difference is that Staff replaced MAWC's estimate of costs associated with ISRS plant additions for February and March 2020 with the costs associated with the actual cost of additions for those months. With that substitution, Staff's recommended ISRS revenue requirement for MAWC in this petition is $9,725,687.

During the course of its review, Staff did not discover any costs that were charged to ISRS eligible projects that did not meet ISRS requirements.

NET OPERATING LOSSES

Net operating losses ("NOLs") occur when a business entity's total available tax deductions for a year exceed the amount of taxable income the business incurs for the same period. The amount of excess tax deductions is termed an "NOL" and, under the current Internal Revenue Service ("IRS") Code ("Code"), that amount may be available to offset taxable income that may be incurred in later years.

In recent ISRS petitions, MAWC has claimed that an existence of an NOL amount on its books during the ISRS period precluded the Commission from recognizing certain income tax deductions (accelerated depreciation, repair allowance) otherwise available to MAWC in ISRS rates, due to the normalization restrictions applicable to regulated utilities in the Code. Staff and The Office of Public Counsel ("OPC") disagreed with MAWC's position on this issue, with Staff noting in particular that no NOL amount was actually generated by MAWC during the ISRS periods in question or was caused by ISRS plant additions. In Case Nos. WO-2018-0373 and WO-2019-0184, the Commission agreed with Staff and OPC and reflected the full amount of the applicable accelerated depreciation and repair allowance deductions available to MAWC in setting ISRS rates.

Following issuance of the Commission's Report and Order in Case No. WO-2018-0373, MAWC made a request for a Private Letter Ruling ("PLR") with the IRS, generally inquiring whether the Commission's treatment of NOLs in setting MAWC's ISRS rates constituted a violation of the normalization restrictions contained within the Code. The PLR request was filed with the IRS on June 6, 2019.

While MAWC's PLR request was pending, MAWC and Staff entered into a stipulation and agreement in Case No. WO-2019-0389[1] that, in the event that the IRS would rule in MAWC's favor regarding the disputed NOL amounts in that and prior ISRS cases, called for the NOL amounts to be deferred through an Accounting Authority Order ("AAO") and recovered in subsequent MAWC rate proceedings. However, no deferral was to take place until any decision that might affirm MAWC's position was issued by the IRS.

The PLR was issued by the IRS in early December 2019, and was filed with the Commission on December 9, 2019. Staff has reviewed the PLR for its potential impact on this proceeding, and through its analysis concludes that within the PLR the IRS determined that the Commission's actions in reflecting a full deduction of applicable accelerated depreciation amounts without offset for an NOL amount in ISRS did constitute a violation of the Code's normalization restrictions. However, the IRS also ruled that the Commission's treatment of reflecting a full deduction of applicable repair allowance amounts did not violate the normalization restrictions within the Code.

The consequences of a violation of the Code's normalization restrictions to a utility and, ultimately, its customers, can be serious. Consequently, consistent with its understanding of the IRS' rulings in the recent PLR, due to the continuing existence of an NOL on MAWC's books during this ISRS period Staff has removed any deduction for accelerated depreciation associated with ISRS plant additions from its calculation of MAWC's ISRS revenue requirement.

As previously discussed, it was stipulated in an earlier case that amounts from prior ISRS cases in dispute should be deferred through an AAO in the event that the IRS found in MAWC's favor. However, in this proceeding, MAWC is proposing that the amount in question (approximately $35,000) should be immediately collected from customers in rates through an increase to the ISRS revenue requirement in this case. Because the past NOL amount to be provided to MAWC

[1] While the stipulation and agreement was entered into by MAWC and Staff, as no party filed an objection to it, the Commission chose to consider it as unanimous, pursuant to Commission Rule 20 CSR 4240-2.115, and approved the agreement in its November 21, 2019, *Order Approving Partial Stipulation and Agreement and Approving Infrastructure System Replacement Surcharge*, issued in Case No. WO-2019-0389.

due to the PLR is relatively immaterial, Staff does not object to the Company's proposal for collecting this amount in this proceeding in lieu of deferring the amounts through an AAO. Therefore, to account for an NOL amount consistent with the IRS ruling, and the corresponding impact to accumulated deferred income taxes associated with the eligible infrastructure system replacements included in MAWC's current ISRS, Staff has included MAWC's proposed adjustments to the appropriate pretax revenues to be collected in this ISRS.

THE ISRS RATE SCHEDULES

The proposed ISRS rate schedules include a volumetric rate for each affected customer class, with the rate to be determined through the use of the customer class billing determinants from the Company's last rate case, Case No. WR-2017-0285, and the ISRS revenues allocated to each affected customer class. Staff agreed with and used the Company's methodology for calculating the ISRS rates, based on the Company's calculation of the ISRS revenue requirement. The ISRS rates are reflected in Appendix A to this Memorandum.

ASSESSMENTS AND ANNUAL REPORTS

In accordance with established practice regarding the submission of Staff recommendations to the Commission, Staff reviewed the payment history for MAWC's annual Commission assessment fees and the status of MAWC's annual report filings. Based on its review of this information, Staff found that MAWC is current on its quarterly assessment payments and is not delinquent for prior year's assessments. In addition, MAWC requested an extension of time to which to file 2019 Missouri Public Service Commission Annual report. The 30-day extension was approved and the annual report is due on or before May 15, 2020.

STAFF RECONCILIATION

Commission rule 20 CSR 4240-3.650(16) requires a water utility to reconcile the differences between the revenues resulting from the ISRS and the ISRS revenues that were approved by the Commission at the end of each twelve month period that an I SRS is in effect. At this time, MAWC's ISRS has not been in effect for a twelve month period so a reconciliation of ISRS revenues was not required in this case.

STAFF'S CONCLUSIONS

Based upon its investigation and calculations, Staff concludes that the Company's ISRS rates should be designed to recover annual ISRS revenues of $9,725,687. Staff's calculations reflect the overall weighted average cost of capital of 9.44% (tax grossed up rate of return) and MAWC's current depreciation rates, as reflected in the Stipulation and Agreement approved and ordered by the Commission on May 2, 2018, in Case No. WR-2017-0285, MAWC's last general rate case. Staff's calculations reflect the actual ISRS eligible investment placed in service from October 1, 2019, through March 31, 2020. In addition, property taxes on plant placed in service prior to December 31, 2019, will be due within 12 months of this ISRS filing. As such, Staff has included these property taxes in this ISRS revenue requirement.

Staff based its conclusions on an examination of work orders and supporting documentation for the projects included for recovery in MAWC's proposed ISRS filing, as well as from a review of the Stipulation and Agreement in Case No. WR-2017-0285. As a result it is Staff's conclusion that the project costs incorporated within this ISRS filing meet the requirements of the governing statutes as summarized previously in this Memorandum in the discussion of the Company's Petition.

STAFF'S RECOMMENDATION

Based on the above, Staff recommends that the Commission issue an order that:

1. Rejects MAWC's ISRS tariff sheet (YW-2020-0148) filed on March 2, 2020;
2. Approves Staff's recommended ISRS surcharge revenues in this docket in the incremental pre-tax revenue amount of $9,725,687 with a total current and cumulative ISRS surcharge of $31,094,713; and

3. Relieves MAWC from filing an application for an AAO to record a regulatory asset to capture the rate differential to cure any normalization violations, as contemplated in the *Partial Stipulation and Agreement* approved in Case No. WO-2019-0389.

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-2020-0190**
Water Company for Approval to Change an	)	
Infrastructure System Replacement Surcharge	)	
(ISRS)	)	

AFFIDAVIT OF AMANDA C. McMELLEN, ALI ARABIAN AND MATTHEW J. BARNES

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

COMES NOW Amanda C. McMellen, Ali Arabian and Matthew J. Barnes and on their oath declares that they are of sound mind and lawful age; that they contributed to the foregoing Staff Memorandum; and that the same is true and correct according to their best knowledge and belief, under penalty of perjury.

Further the Affiant sayeth not.

/s/ *Amanda C. McMellen*
AMANDA C. McMELLEN

/s/ *Ali Arabian*
ALI ARABIAN

/s/ *Matthew J. Barnes*
MATTHEW J. BARNES