Exhibit No. 125

Staff – Exhibit 125
Matthew Young
Rebuttal Testimony
File No. GR-2021-0108

Exhibit No.:	
Issues:	*Capitalized Overheads,* *Net Operating Loss Carryforward*
Witness:	*Matthew R. Young*
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MISSOURI PUBLIC SERVICE COMMISSION

FINANCIAL AND BUSINESS ANALYSIS DIVISION

AUDITING DEPARTMENT

REBUTTAL TESTIMONY

OF

MATTHEW R. YOUNG

SPIRE MISSOURI INC. d/b/a SPIRE
SPIRE EAST and SPIRE WEST
GENERAL RATE CASE

CASE NO. GR-2021-0108

Jefferson City, Missouri
June 2021

TABLE OF CONENTS OF

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Q. Please state your name and business address.

A. My name is Matthew R. Young. My business address is 615 East 13th Street, Room 201, Kansas City, MO 64106.

Q. Are you the same Matthew R. Young that contributed to the Staff of the Missouri Public Service Commission's ("Staff") Costs of Service Report that was filed on May 12, 2021?

A. Yes, I am.

EXECUTIVE SUMMARY

Q. What is the purpose of your testimony?

A. In this testimony, I will explain that while Staff shares some of the Office of the Public Counsel's ("OPC") concerns regarding Spire's capitalization of overhead costs, OPC's recommendation to establish a tracker for capitalized overheads is not a feasible recommendation.

I also will explain why I do not support OPC's recommendation to exclude Spire's net operating loss deferred tax asset from rate base.

CAPITALIZED OVERHEADS

Q. What are capitalized overheads?

A. The most basic description is capitalized overheads are costs that are indirectly related to a capital project. Overheads of this type are allocated to construction work orders and are ultimately reflected in the plant-in-service component of rate base. Some examples of capitalized overheads are provided by the Uniform System of Accounts ("USOA"), which identifies engineering, supervision, general office salaries and expenses, construction engineering and supervision by others than the accounting utility, law expenses, insurance, injuries and damages, relief and pension, taxes, and interest as indirect capital costs.[1]

Q. What is OPC's concern with Spire's capitalized overheads?

A. Mr. Schallenberg identifies two concerns about capitalized overheads. First, OPC is concerned with the risk of Spire over-capitalizing costs to the extent it would be an abuse of the ISRS surcharge mechanism. Second, OPC is concerned that Spire would use a capitalization methodology that is prohibited by the USOA.[2]

Q. Regarding OPC's first concern, are there any risks regarding the amount and timing of Spire's overhead capitalization?

A. Yes, there are risks that are present with or without an ISRS surcharge and are driven by rate-base regulation as well as accounting methodology. Since the size of a utility's rate base drives the utility's earnings, Spire may find an incentive to increase the amount of capitalized costs for the sole purpose of maximizing it rate of return. Under rate-base regulation, a utility that increases its rate base value can increase the amount included in rates for its opportunity for earnings.

Additionally, Spire can alter its net income through changes to its methodology for accounting for overheads. For example, if Spire were to remove an overhead expense from the income statement (by charging the cost to plant-in-service), the immediate impact would be a

[1] USOA Gas Plant Instruction No. 4.
[2] Schallenberg direct, page 23.

reduction to expenses, which leads to an artificial increase in earnings. In other words, rather than increasing its earnings by controlling costs or increasing revenue, there is a risk Spire would increase its earnings by manipulating its capitalization accounting methodology and at the same time, increase the size of its regulated rate base.

Q. Is there an audit risk that is specific to the ISRS surcharge?

A. Yes. A consequence of the single-issue ratemaking nature of the ISRS surcharge is that it creates an incentive for Spire to maximize the costs charged to ISRS eligible work orders. The ISRS surcharge presents an opportunity for Spire to increase its revenue without the need of a rate case, which would consider all relevant factors to establish a holistic cost of service. Additional incentive is added through the mitigation of regulatory lag that the ISRS surcharge provides. As such, Spire has an incentive to maximize its ISRS revenue which can be achieved by inflating the cost of ISRS-eligible rate base via excessive capitalized overheads.

Q. Are you asserting that Spire is manipulating rate case regulation or the ISRS surcharge for profit maximization?

A. No, I am not making that assertion. I am merely describing the risks and incentives relevant to Spire.

Q. Is there anything restraining Spire from overcharging ratepayers in its base rates or via the ISRS surcharge through excessive overhead capitalization?

A. Yes. The guidance and enforcement of the USOA, specifically General Plant Instruction Nos. 3 and 4, restrain Spire from charging an undue amount of capitalized overheads to ratepayers through the ISRS surcharge and base rates in general.

Q. Did OPC identify how much of its overheads Spire charged to construction?

A. According to Mr. Schallenberg's direct testimony, Spire capitalized about $173 million of overhead costs during the test year.[3]

Q. Did Staff quantify the amount of overheads Spire charged to construction?

A. No. During Staff's audit, Staff found that the definition, identification, and quantification of capital overhead costs is not readily identifiable in Spire's books and records and, therefore, its rate base. To illustrate, of the $173 million shown by Mr. Schallenberg, Staff cannot separate the amount of capitalized overheads into the classes listed by the USOA (e.g. labor, legal, pensions, office supplies, etc.) or into Spire's own cost accounting system.

Q. What is OPC's recommendation to address its concerns?

A. Mr. Schallenberg recommends that the Commission authorize a tracker to capture the amount of capitalized overheads that exceed the base amount included in this rate case.

Q. Do you support this recommendation?

A. No, I do not support that recommendation for a couple of reasons. First, I do not believe the proposed tracker meets the standards set forth by Commission precedent. While trackers are evaluated on a case-by-case basis, the use of trackers generally is justified under the following circumstances: (1) when the applicable costs demonstrate significant fluctuation and up-and-down volatility over time, and for which accurate estimation is difficult; (2) new costs for which there is little or no historical experience, and for which accurate estimation is accordingly difficult; and (3) costs imposed upon utilities by Commission rule. Spire's capitalized overheads are simply not a cost that fits the listed criteria.

[3] Schallenberg direct, page 25.

Second, I believe implementing a tracker would be mechanically problematic. As discussed above, Staff has been unable to identify and quantify Spire's overhead costs and will not be able to do so in the foreseeable future. Without a quantified baseline of capitalized overheads that are included in the current case, a comparison of ongoing capitalized overheads will likely prove controversial and will lead to arbitrary recommendations.

Q. What recommendation did Staff make regarding capitalized overhead issue?

A. Staff recommended that, on a going-forward basis, the Commission should order Spire to cease capitalizing non-operational overhead costs, or as an alternative order Spire to cease capitalizing costs received from Spire Services, until such a time that Spire can demonstrate its compliance with the USOA.[4]

Q. Did OPC make further recommendations regarding ongoing capitalized overheads?

A. Yes. OPC recommended that Spire submit ongoing reports on capitalized overheads and their relationship to ISRS eligibility.

Q. What is your response to this recommendation?

A. Staff is not opposed to receiving ongoing data so long as the reports are crafted to provide useful information. Staff would consider information useful if it demonstrated Spire's capitalized overhead methodology in a transparent and detailed format so that the costs included in ISRS and non-ISRS rate base can be evaluated against the guidance in the USOA.

<u>NET OPERATING LOSS CARRYFORWARD</u>

Q. Please summarize OPC's testimony on Spire's net operating loss deferred tax asset ("NOL Asset").

[4] Staff Cost of Service report, pages 31-33.

A. In his direct testimony, Mr. Riley recommends excluding Spire's NOL Asset balance from two calculations; the rate base calculation of Accumulated Deferred Income Taxes ("ADIT") and the amortization of Spire's excess ADIT.

Q. Why does Mr. Riley recommend excluding Spire's NOL Asset from the ADIT in rate base?

A. Mr. Riley asserts that a net operating loss ("NOL") does not have a true cost attributable to it and also does not have a cash consequence to the utility, so no amount of a NOL Asset should be included in the ratemaking calculation of ADIT.

Q. Do you agree with Mr. Riley's representation of a NOL and Spire's NOL Asset?

A. No.

Q. In general, what does the ADIT rate base offset represent?

A. The ratemaking concept of ADIT is a measurement of the tax savings Spire has received from the Internal Revenue Service ("IRS") but has not passed onto ratepayers through the ratemaking process. ADIT is the summation of normalized book/tax timing differences (caused by tax deductions) that are temporary in nature and will become a tax liability to Spire in future periods. Since Spire is able to use book/tax timing differences to avoid paying current income taxes, the ADIT balance represents an amount of cash Spire has avoided spending on its past income tax liabilities and is considered a cost-free loan from the federal government.

Q. What does a NOL represent?

A. Page six of the Commission's Report and Order in Missouri American Water Company's ISRS Case No. WO-2020-0190, Finding of Fact No. 18 provides a succinct definition for a NOL:

> The term 'net operating loss' is defined as "the excess of operating expenses over revenues." An NOL results when a

> utility does not have enough taxable income to utilize all of the tax deductions to which it would otherwise be entitled. When this situation occurs, the amount of the unused deductions is referred to as an NOL and is booked to a deferred asset account.

I would add that a NOL Asset is defined as the balance of the accumulation of all prior NOLs.

Q. What does it mean when a utility does not have enough taxable income to utilize all of the tax deductions?

A. If a utility was unable to utilize all of its tax deductions, it means that after the utility has reduced taxable income with all of its tax deductions, it was not able to take advantage of some portion of the cost-free loan from the federal government that is embedded in tax law. Mechanically, the utility would not have been able to fully take advantage of its tax deductions because its taxable income was reduced to a negative amount.

Q. How is a NOL created?

A. As described above, tax deductions are meant to reduce the tax liability and in some instances, generate "cost-free funds" through the deferral of income tax payments from the current period to future periods. However, once the utility's taxable income is reduced to $0 in a given tax year, the realization of the cost-free funds ceases. To the extent the sum of a utility's temporary book/tax timing differences creates negative taxable income (goes below $0), there is not a current tax benefit of the utility's tax deductions. In this scenario, the utility is allowed to defer the amount of tax deductions that would have reduced taxable income, if there had been any, to future periods, where a tax liability may exist. Spire records the amount of temporarily foregone accumulated tax benefits as a NOL Asset as it is an economic benefit that Spire will realize in the future.

Q. Did Staff include Spire's NOL Asset in its calculation of ADIT?

A. Yes. Staff's calculation represents the accumulated cash consequences of tax benefits Spire has realized from its book/tax timing differences at December 31, 2020. Since the NOL Asset represents a tax benefit Spire has not yet realized at that date, it is appropriate to include the tax asset as an offset to total ADIT.

Q. Do you agree with Mr. Riley that a NOL has no cost and is merely a product of legislation; therefore, it has no basis in a utility company's checkbook?[5]

A. I agree that the accounting for NOLs is ultimately necessary because of tax legislation but Mr. Riley's logic is flawed. OPC's arguments regarding the cause and effect relationship between legislation and NOLs can also be applied to the relationship between the same legislation and ADIT. By making this argument, Mr. Riley is effectively using the existence of tax legislation to recommend a reduction to rate base via ADIT liabilities, but argue against including the NOL Asset balance that exists because of the same legislation. OPC's testimony has not successfully defined the difference between the tax laws that should affect Spire's regulated rate base and the tax laws that should be ignored in ratemaking.

Q. On page 12 of his direct testimony, Mr. Riley also recommends excluding an amortization of the NOL Asset balance from the amortization of Spire's excess ADIT. What is excess ADIT?

A. In this instance, excess ADIT is defined as the balance of book/tax timing differences that, due to the Tax Cuts and Jobs Act of 2017 ("TCJA"), were reclassified from temporary to permanent differences. In addition to the TCJA, excess ADIT was created when Missouri reduced its corporate tax rate from 6.25% to 4%. Spire's calculation of excess ADIT related to certain method/life timing differences includes a NOL offset.

[5] Riley direct, page 12.

Q. What is Mr. Riley's recommendation regarding this particular NOL offset?

A. Mr. Riley recommends excluding Spire's NOL Asset from this calculation for the same reasons he recommends exclusion of the NOL Asset from the ADIT component of rate base.

Q. Do you agree with Mr. Riley?

A. Not for the reasons provided in his direct testimony.

Q. Please explain.

A. As described above, excess ADIT exists because timing differences that were temporary in nature transitioned to permanent differences due to federal and state tax reform. Since the tax benefits were no longer temporary, ratepayers would not have received the benefits in future periods so it is appropriate to return the excess ADIT through ongoing amortizations. However, it may not be appropriate to offset the return of excess ADIT to ratepayers with an amortization of Spire's NOL Asset unless some portion of the asset has also transition from a temporary deferral to a permanent difference. Staff has issued discovery on this topic and may have an updated recommendation for the Commission in future testimony.

Q. Does this conclude your rebuttal testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Spire Missouri Inc.'s d/b/a Spire Request for Authority to Implement a General Rate Increase for Natural Gas Service Provided in the Company's Missouri Service Areas	)))))	Case No. GR-2021-0108

AFFIDAVIT OF MATTHEW R. YOUNG

STATE OF MISSOURI)
) ss.
COUNTY OF JACKSON)

COMES NOW MATTHEW R. YOUNG and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing *Rebuttal Testimony of Matthew R. Young*; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

Matt Young

MATTHEW R. YOUNG

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Jackson, State of Missouri, at my office in Kansas City, on this 15th day of June 2021.

Eboney Jackson-Spotwood

Notary Public

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI

EBONEY JACKSON-SPOTWOOD
My Commission Expires
April 8, 2023
Clay County
Commission #19965798