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Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102

**RE: Comments of Home Builders Association of St. Louis and Eastern Missouri
on Missouri American Water Company’s Proposed Tariff
File No. WW-2018-0388**

Please accept these comments of the Home Builders Association of St. Louis and Eastern Missouri (hereinafter “HBA”) on P.S.C. Mo. No. 13, 1st Revised Tariff Sheet No. R.65 (hereinafter “Proposed Tariff”) filed by Missouri American Water Company (“MAWC”) regarding “contributions in aid of construction” (hereinafter “CIAC”) following enactment of the Tax Cut and Jobs Act, P.L. 117-97 (hereinafter “TCJA”).

The HBA has more than 630 member-companies employing more than 47,000 in connection with the residential home building industry in the City of St. Louis and counties of St. Louis, St. Charles, Jefferson, Lincoln, Pike, Montgomery, Franklin, Warren, and Washington. HBA works to promote economic development, a strong residential construction industry (and the jobs it creates both directly and indirectly), and affordable homeownership. HBA’s home builder members undertake residential development projects within the territory of MAWC as well as in areas served by municipal and other publicly-owned water companies.

Each year, HBA members invest millions of dollars in water infrastructure that is ultimately donated to the water utility. This donated infrastructure provides significant benefit to MAWC and its existing customers by providing millions of dollars in new utility plant at no cost to the water company. For more than 20 years, investor-owned water companies like MAWC enjoyed a tax exemption for CIAC, pursuant to which CIAC was not considered part of the company’s taxable income for federal and state tax

purposes and was instead considered a contribution to capital. On December 22, 2017, the President signed into law the TCJA, which *inter alia*, eliminated the tax exemption for CIAC, providing that CIAC is to be treated as ordinary taxable income. This change was made despite the fact that investor-owned utilities are prohibited from including CIAC in their rate base, and therefore CIAC does not generate income for the utility.

Following passage of the TCJA, MAWC began demanding HBA's homebuilder members make an advance payment to MAWC of the entire federal and state tax purportedly owed by MAWC relating to CIAC. MAWC indicated that advance payment from developers was required by the TCJA and MAWC's current tariff governing CIAC, Tariff Sheet No R. 65 (hereinafter "Current Tariff"). MAWC required this payment as a condition of entering into a service agreement for a development. Such agreements are executed prior to the CIAC being constructed and subsequently accepted by MAWC into its system. Initially, MAWC was requiring developers to make a payment of approximately 39% (which was based on the pre-TCJA federal rates). After questions from developers, MAWC began demanding payment of 25% of the MAWC-estimated cost of the CIAC to be contributed.

Over the past few months, the advance payment of this new tax liability of the utility as a condition of agreeing to provide service has resulted in home builders being required to make unbudgeted and unanticipated outlays of hundreds of thousands of dollars in order to begin long planned developments. This unanticipated payment has caused the cost of residential developments to increase by as much as \$3,000 to \$5,000 per lot in MAWC's service territory, which, if passed on to new homebuyers, would increase new home prices by several thousand dollars per home. In addition, because the elimination of the CIAC tax exemption does not impact publicly-owned water companies (such as municipalities and public water districts), requiring developers to make advance payment of MAWC's tax liability makes development in areas served by MAWC less competitive than in areas served by publicly-owned systems, providing a disincentive for developers to undertake projects in MAWC's service area. This has a detrimental effect on the existing customers of MAWC, as absent development, there are no new customers over which to spread MAWC's fixed costs.

Facing this significant impediment to new residential developments in MAWC's service territory, HBA brought the issue to the attention of PSC Staff and filed an application for rehearing in MAWC's then-pending general rate case. In response to HBA's application for rehearing, MAWC indicated that the Current Tariff "may need to be revised to ensure that applicants for extension of service pay only the 'net' increased tax expense associated with CIAC" and that MAWC anticipated "making a revised tariff filing with the Commission." *See MAWC Response to Application for Rehearing*, ¶ 7.

On June 15, 2018, MAWC filed its Proposed Tariff. *See P.S.C. Mo. No. 13, 1st Revised Tariff Sheet No. R.65*. In place of the full gross-up approach of the Current

Tariff, the Proposed Tariff purports to adopt a present value approach, with the tax paid by the developer off-set by the present value of the tax savings that result from tax depreciation over the life of the contributed assets. Based on the example calculation filed by MAWC, the Proposed Tariff calls for roughly 13.8% of the CIAC to be paid in advance by the CIAC contributor. *See Response to Order Opening Working Case and Scheduling a Workshop Meeting, Appendix A.*

On June 25, 2018, PSC Staff filed a motion asking the Commission to open a case and schedule a workshop meeting at which interested stakeholders can learn more about the proposed tariff and in which stakeholders can submit comments to PSC Staff as it considers the Proposed Tariff. *See Motion to Schedule Workshop.* The PSC granted the motion on June 27, 2018, setting the workshop for July 19, 2018. *See Order Opening a Working Case and Scheduling a Workshop Meeting.*

HBA Comments on the Proposed Tariff

I. The Proposed Tariff Is Inequitable

By calling for the contributor of CIAC rather than the utility to make an advance payment of the utility's taxes, the Proposed Tariff imposes significant additional and unanticipated costs on the developers who invest in and contribute the infrastructure, without recognizing the significant benefit to MAWC and its existing customers resulting from the developer's investment and new residential development it makes possible. This additional cost also makes new homes less affordable in MAWC's service territory by imposing several thousand dollars per home in additional development costs.

In addition, the Proposed Tariff puts residential development in MAWC's service territory at a competitive disadvantage to development in comparable areas served by publicly-owned utilities, by adding several thousand dollars in development cost to each lot in an area served by MAWC that are not imposed in areas served by publicly-owned utilities. This discourages residential development in MAWC territory, reduces the amount of new infrastructure developers contribute for the benefit of MAWC's system, and reduces the number of new customers the residential development brings to help offset MAWC's fixed costs overall.

II. A No-Gross-Up Approach Should Be Adopted

The approach of the Proposed Tariff fails to recognize developers' significant investment in the new infrastructure contributed to the utility as CIAC, along with the new customers and new revenues the developers' investment brings to MAWC's service area. To account for these benefits to MAWC and its customers and to prevent costly impediments to new residential development in MAWC's service territory, MAWC and the Commission should adopt the "no gross-up" method of billing and accounting related

to CIAC. The no gross-up method is a just, reasonable, lawful, and nondiscriminatory approach to addressing the changes in taxability of CIAC under the TCJA.

Under the no gross-up method, the utility pays the taxes on CIAC, instead of collecting it from the developer. Income taxes associated with the CIAC are recorded in a deferral account equivalent to recording a deferred tax asset (DTA) and, as such, will reduce accumulated deferred income tax (ADIT) liabilities in future base rate cases. Future tax depreciation funded by non-grossed-up CIAC will cause the deferred tax asset to reverse over its tax life, thus increasing net ADIT liabilities as tax benefit of the additional depreciation is realized. Such future depreciation reduces tax expense for ratemaking purposes in future base rate cases.

The following tariff language is recommended in lieu of the Proposed Tariff in order to provide a no gross-up method of accounting for taxes associated with CIAC:

***TAXES ON DEPOSITS FOR CONSTRUCTION, CUSTOMER
ADVANCES, AND CONTRIBUTIONS IN AID OF CONSTRUCTION***

The Company will pay income taxes on any deposit, advance, contribution or other like amounts and/or assets received from an applicant which shall constitute taxable income to the Company as defined by the Internal Revenue Service. Such income taxes shall be segregated in a deferred account for inclusion in rate base in a future rate case proceeding. Such income tax associated with a deposit, advance, or contribution will not be charged to the specific depositor / contributor of the capital.

Under the no gross-up method, income taxes paid by MAWC are not charged to the party paying the CIAC, nor are they included in revenue requirement used to establish rates for service to other customers. Future tax depreciation will provide a tax benefit (through depreciation deductions) that equals the nominal amount of the income tax paid by MAWC when the CIAC was included in its taxable income in the year the contribution was received. The time value associated with the lag between MAWC's payment of income taxes and future recovery of those amounts through depreciation deductions is recognized by the increase in rate base that results from treating the deferred amount as a deferred tax asset that offsets ADIT. When the no gross-up method is employed, the Internal Revenue Service's regulations require the tax-book timing difference to be normalized by reflecting the deferred amount in rate base.

Any cost associated with rate base will be offset by the additional revenue generated from the additional customers over whom to spread fixed costs of MAWC and as a result of the utility being able to continue to receive developer-funded CIAC. A no gross-up approach will enable MAWC to continue to accept CIAC, which does not require investment by MAWC, but nonetheless provides its customers with additional and upgraded utility infrastructure and enhances MAWC's ability to provide service at a

reasonable cost. CIAC results in additional customers for MAWC and these additional customers provide a larger basis to spread its overall cost of service to all customers. Thus, under the no gross-up method, MAWC customers would not be negatively impacted, because any tax expense included in rate base will be offset by depreciation on the contributed assets and by the additional revenue generated from additional customers and the ability of MAWC to continue to receive CIAC.

A no-gross up approach will also allow the Commission to consider tax issues overall as part of a rate proceeding so that the full impact of the TCJA and other tax changes may be considered together, instead of the CIAC change considered in isolation. For example, the TCJA repeals corporate AMT for tax years after December 31, 2017, which would allow any AMT credit carryovers in future tax years to be utilized against a taxpayer's regular tax liability. In addition, in 2018-2020, if the AMT credit carryover exceeds regular tax liability, up to 50% of the excess AMT credit carryovers are refundable and, beginning in 2021, any remaining AMT credit carryovers will become fully refundable. As a result of this change, if MAWC uses AMT credit carryovers to offset tax liability (or provide a refund), the tax impact from the CIAC should be reduced in proportion to all of the other company's other income that generates tax liability. A no gross-up approach allows the Commission to consider all aspects of the utility's income taxation—including all impacts from the tax changes of the TCJA in single proceeding—rather than what is tantamount to a single-issue proceeding.

III. The Proposed Tariff Fails to Ensure that CIAC Contributor Pays Only the “Net” Increased Tax Expense

In its response to HBA's Application for Rehearing, MAWC represented that it would file a revised tariff “to ensure that applicants for extension of service pay only the ‘net’ increase tax expense associated with CIAC.” *See Response to Application for Rehearing*, ¶ 7. The Proposed Tariff fails to ensure this for a variety of reasons.

First, the Proposed Tariff fails to require the company to include the required refund amount in the total cost of the depreciated asset value for purposes of calculating the present value of the tax benefit achieved by tax depreciation. If MAWC is going to take depreciation on the total amount of the CIAC, then the refund should be included in determining the tax benefit from the depreciation. Accordingly, unlike as depicted in MAWC's example, the tax benefit should be calculated on 100% rather than 95% of the asset. *See Response to Order Opening Working Case and Scheduling a Workshop Meeting, Appendix A.*

Additionally, the Proposed Tariff fails to take into account the time value of the developer's tax payment to MAWC, which could be up to 18 months in advance of when MAWC is required to pay the taxes.

Even more problematic, in calculating the value of the CIAC, MAWC initially used estimated costs that were significantly higher than the actual cost the developer would incur. If the tax on CIAC is to be placed on the developer, the CIAC cost used to determine the tax should be no greater than the actual cost the developer incurs and the amount of the advance payment should be so limited to ensure that the company is not over-collecting.

IV. The Commission Should Support Efforts to Modify the TCJA to Continue the CIAC Exemption

The purpose behind making CIAC taxable for water utilities under the TCJA appears to be based on a misunderstanding on the part of the drafters. The drafters appear to have believed that investor-owned water utilities were receiving income that was not being taxed as a result of the CIAC contribution. However, the utilities were not allowed to include CIAC in their rate base and therefore do not earn income on those assets. In recognition of this, efforts are underway to address this issue through federal legislation that would provide a fix for a number of issues that have been identified with the TCJA following its passage, including the change related to the taxation of CIAC for water utilities.

Such efforts are more likely to succeed with the joint engagement of the National Association of Utility Regulatory Commissioners (“NARUC”), the National Association of Home Builders (“NAHB”) and the National Association of Water Companies (“NAWC”) to correct this misunderstanding of the nature of CIAC. HBA is participating in such efforts and would welcome any assistance the Commission, through NARUC, could provide. With Chairman Hall’s current role as Co-Chair of NARUC’s Committee on Water, Missouri may have an opportunity to provide leadership on an issue that state regulators, water utilities and developers throughout the country are currently working to address.

Thank you for the opportunity to submit comments and participate in this workshop on this critical issue affecting residential construction, homebuyers and water customers throughout the state.

Sincerely,

A handwritten signature in black ink, appearing to read "Chris Pieper". The signature is fluid and cursive, with the first name "Chris" being more prominent and the last name "Pieper" following in a similar style.

Chris Pieper