CORRECTED
DIRECT TESTIMONY
OF
JOHN S. RILEY
THE EMPIRE DISTRICT ELECTRIC COMPANY
CASE NO. ER-2018-0366

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. What is your educational background?

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

Q. What is your professional work experience?

A. I was employed by the OPC from 1987 to 1990 as a Public Utility Accountant. In this capacity I participated in rate cases and other regulatory proceedings before the Public Service Commission ("Commission"). From 1994 to 2000 I was employed as an auditor with the Missouri Department of Revenue. I was employed as an Accounting Specialist with the Office of the State Court Administrator until 2013. In 2013, I accepted a position as the Court Administrator for the 19th Judicial Circuit until April, 2016 when I joined the OPC.

Q. Are you a Certified Public Accountant ("CPA") licensed in the State of Missouri?

A. Yes. I am also a member of the Institute of Internal Auditors ("IIA")

Q. Have you previously filed testimony before the Missouri Public Service Commission ("Commission" or "PSC")?

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

Q. What is the purpose of your testimony?

A. I provide to the Commission the Office of the Public Counsel's ("OPC") positions regarding the adjustments that should be made to change the electric rates of The Empire District Electric Company ("Empire") in this case due to § 393.137, RSMo.[1]. It is OPC's position that the purpose of Senate Bill 564 and this case is to flow to Empire's Missouri customers the full impacts of the federal Tax Cut and Jobs Act of 2017 ("TCJA") which went into effect on January 1, 2018.

Q. What are OPC's positions?

A. OPC's positions are that four adjustments to Empire's annual Missouri electric revenue requirement used for setting its current rates are required to reduce Empire's electric rates to flow to Empire's Missouri customers the full impacts of the TCJA.

- The first adjustment is to reflect going forward the change in the federal corporate income tax rate from 35% to 21%. OPC has quantified this adjustment to be a revenue requirement reduction of $17,469,270.

- The second adjustment (protected excess Accumulated Deferred Income Taxes) is to reflect the differences between the amounts for federal income taxes that Empire has collected from its customers through rates and what it paid attributable to depreciation which federal tax law requires flow to customers over remaining plant life. ~~Because neither OPC nor Empire have the rate the federally required average rate assumption method yields, although Empire represents that it has the data to determine that rate, OPC cannot now quantify the~~ OPC has quantified the appropriate reduction to Empire's Missouri electric revenue requirement~~. However, OPC has quantified the amount to~~

[1] Section 393.137 creates a ninety day period to adjust rates for electrical corporations to reflect the changes in the income tax component of the revenue requirement.

~~which that rate will~~ to be ~~applied~~$8,729,631. This $8,729,631 is based on OPC's quantification of Empire's current protected excess ADIT to be $~~175,044,036~~130,161,870, a tax gross-up factor of 1.34135, and the same 20-year amortization period the Commission used for Spire Inc.'s protected excess ADIT, with a tracker.

- The third adjustment (unprotected excess Accumulated Deferred Income Taxes) is to reflect the differences between the amounts for federal income taxes that Empire has collected from its customers through rates other than those amounts that are protected, and included in the second adjustment. OPC has quantified the appropriate reduction to Empire's Missouri electric revenue requirement to be $2,288,455. This $2,288,455 is based on OPC's quantification of Empire's current unprotected excess ADIT to be $~~22,884,547~~17,016,835, a tax gross-up factor of 1.34135, and using the same 10-year amortization period Union Electric Company agreed to for unprotected excess ADIT.

- The fourth adjustment is to reflect Empire's recovery from its Missouri electric customers of its federal income tax from January 1, 2018, until new rates take effect that is based on a federal corporate income tax rate of 35% when the actual rate is 21%. Assuming the new rates take effect August 30, 2018, OPC has quantified that accumulated amount to be $11,582,365 (242/365*$17,469,270).

Q. What adjustments should be made to address the impacts of the TCJA?

A. To fully address the impacts of the TCJA on electric utility rates, four (4) separate adjustments are required. The first adjustment is to reflect in Empire's current electric rates the change in the federal corporate income tax rate from 35% to 21%, which reduces Empire's federal income tax component of the cost of service. The second and third adjustments are to reflect in Empire's current electric rates the amounts its customers were charged in their rates for federal income tax expense that Empire has yet to pay to the Internal Revenue Service ("IRS"). These adjustments both are commonly referred to as excess accumulated deferred income tax ("ADIT"), one being "protected" and the other "unprotected." "Protected" is ADIT where federal law effectively limits how quickly the accumulated deferred income tax amounts are flowed to Empire's customers in the rates they pay. "Unprotected" is ADIT where the deferral is caused by something else, e.g., capitalizing an expense for ratemaking purposes that is treated as an expense for federal income tax purposes. OPC's second adjustment is for "protected" excess ADIT and its third adjustment is for "unprotected" excess ADIT. The fourth adjustment is to recognize that when the Commission established Empire's current electric rates Empire's federal income tax rate was 35%, but that tax rate changed to 21% on January 1, 2018. Therefore, the fourth adjustment is to recognize the impacts of that 40% difference in federal income tax rates from January 1, 2018, to the date new rates set in this case take effect.

Q. Has OPC quantified each of these four adjustments?

A. Yes.

Q. How did OPC quantify the first adjustment, i.e., to reflect in Empire's current rates the change in the federal corporate income tax rate from 35% to 21%, which reduces Empire's federal income tax expense?

A. OPC used one of the spreadsheet developed by Empire to answer OPC data request 1301. Empire used a composite (state and federal) tax rate of 25.12% where Staff, OPC and other utilities have used a rate of 25.45% for tax changes in other cases. I inserted a new column in the spreadsheet and used the 25.45% and the gross up factor of 1.34135. This is attached as Schedule JSR-D-2

Q. What is OPC's quantification of the first adjustment?

A. OPC estimates that Empire's annual Missouri electric revenue requirement is overstated by $17,469,270 due to the reduction in the federal corporate income tax rate from 35% to 21%.

Q. What is OPC's quantification of its second and third adjustments— "protected" and "unprotected" excess ADIT, respectively?

A. I calculated that, for its Missouri electric operations, Empire has a total excess ADIT of $197,~~928,583,~~477,172 (factored up by a tax gross-up factor of 1.34135), of which $~~175,044,036 is~~174,592,625is protected and $22,884,547 is unprotected. Schedule JSR-D-4 page 2 of 3 and 3 of 3

Q. What steps did you take to calculate these estimates?

A. OPC issued data requests for business records and communications, primarily to determine the amount of protected and unprotected ADIT. Empire provided answers to OPC data requests for information about Empire's ADIT on the afternoon of July 5. OPC also deposed Mr. Steve Williams, a CPA with Empire, on Friday, July 6 in an effort to clarify Empire's position on ADIT. Not until it provided its response to OPC data request 1303 on the afternoon of July 5 did Empire inform OPC that it would make its 2015 and 2016 consolidated federal income tax returns available for viewing at its "regional headquarters located at 602 S. Joplin, Ave., Joplin, MO," and that "arrangements can be made to view the materials at the Company's outside legal counsel office located in Jefferson City." I reviewed Empire's 2016 consolidated federal income tax return the afternoon of July 6.

After listening to Mr. Williams' answers to OPC deposition questions and reviewing the documentation that Empire provided, as well as reviewing Empire's 2016 consolidated tax return, I made adjustments to Empire spreadsheets and calculated the excess ADIT and identified the protected and unprotected components. Although Empire personnel have stated that Empire believes the excess ADIT is mostly protected, and should be flowed back to ratepayers over 30 to 40 years, internal communications between Empire and Liberty personnel provided to OPC in its responses to OPC data request nos. 1001, 1301, 1302, and 1303 indicate that Empire has categorized a significant portion of its excess ADIT as being unprotected.[2]

Q. What is OPC's recommendation to the Commission regarding the amount of Empire's protected excess ADIT (second adjustment)?

A. In the most recent Spire Inc. rate case, the Commission decided a 20 year amortization with a tracker was an appropriate timeframe. This would be OPC's recommendation due to Empire's lack of information to develop accurate flow back timeframes.

The IRS requires that the Average Rate Assumption Method (ARAM) be used to flow back the excess ADIT, however, emails obtained from the Company indicate that it cannot sufficiently identify the asset lives to follow the ARAM method. The IRS will allow utilities to amortize the excess using what is known as the Reverse South Georgia Method. In short, the method uses an average composite depreciation rate to calculate the amortization amount. Preliminary calculations indicate that the composite rate is about 2.96% however, -I have not seen any information from the Company regarding this method either. Until the Company can identify the proper amortization rate, the OPC recommends what the Commission established in the Spire Inc. rate case.

Using a 20 year amortization to apply to the $~~175,044,036~~174,592,625 ($130,161,870*1.34135), balance allows a reduction in Empire's revenue requirement by **$8,~~752,202~~729,631**.

Q. What is OPC's recommendation to the Commission regarding the amount of Empire's ADIT that is unprotected?

[2] Company personnel have stated in emails that they believe that account 282100 is an unprotected amount.

A. OPC believes the amount of unprotected excess ADIT (factored up by a tax gross-up factor of 1.34135) is $22,884,547 (Missouri electric operations). Unlike protected ADIT, the Commission may flow unprotected ADIT to ratepayers over time periods set by the Commission, or as Empire employee Steve Williams artfully articulated the standard, at the "whim of the PSC"[3].

Q. What is OPC's recommendation to the Commission regarding the time over which this $22,884,547 ~~of unprotected excess ADIT~~ should be flowed to Empire's Missouri electric ratepayers?

A. In this case, as it has recommended in prior TCJA cases, OPC recommends that the Commission use a 10-year amortization period, Applying a 10 year period to the flow back of the $22,884,547 would reduce Empire's revenue requirement by $2,288,455 ($22,884,547/10).

Q. What is OPC's quantification of the fourth adjustment, i.e., the impacts of that 40% difference in federal income tax rates from January 1, 2018, to the date new rates set in this case take effect?

A. Because of the 90 day timeframe established in SB 564, new rates must be in place by August 30 of this year. Based on the assumption that the new rates take effect August 30, 2018, OPC has quantified the accumulated amount to be $11,582,365 (242/365*$17,469,270). Statute requires this amount to be deferred to the Company's next general rate case.[4]

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[3] Email included in Schedule JSR-D-3

[4] SB 564, section 393.137 "…to defer to a regulatory asset the financial impact of such federal act on the electrical corporation for the period of January 1, 2018, through the date the electrical corporation's rates are adjusted on a one-time basis...... to set the electrical corporation's rates in its subsequent general rate proceeding

Q. How is OPC recommending this amount be flowed to Empire's Missouri customers?

A. Within the next rate case, OPC recommends treating the sum of the fourth adjustment as a reduction to the cost of service amortized over the expected period rates are in effect. i.e. If Empire is expected to file a rate case every four years, the $11,~~646,180~~582,365 will flow back to the customer at $2,~~911,545~~895,591 annually. (11,~~646,180~~582,365/4).

Q. What is the full impact of the tax changes when considering OPC's recommendations?

A. The change in rates will reduce Empire's revenue requirement by $17,469,270 annually. The 20 year amortization of the protected portion of the excess ADIT will reduce rates by $8,~~752,202~~729,631 a year. The 10 year amortization of the unprotected portion will reduce rates by $2,288,455. The total reduction that OPC seeks by August 30, 2018 is $28,~~509,927~~487,356 on an annualized basis with an additional reduction of $2,~~911,545~~895,591 in the next general rate case.

Q. How does OPC's recommend the Commission change Empire's rates to implement the rate reductions from the new tax law?

A. OPC recommends that the full impact of the new tax law be reflected by reductions in Empire's customer charges. Reducing customer charges best will ensure that Empire's customers will realize the benefits of the TCJA as the Missouri Legislature contemplated in Senate Bill 564. Customer charges are finite, and have a greater degree of predictability to insure that bills are not be reduced in an amount any more or less than the Commission intends. Changes to volumetric rate elements may vary based on consumption, which may be influenced by factors such as weather. The point is that this money has been, in fact, collected from ratepayers, and the customer charges are the more accurate mechanism to return ratepayers' monies, short of a direct refund. Because the statute authorizes rate adjustments to realize the benefits of the TCJA, OPC recommends adjustments to the customer charge.

Q. Are you aware that the Commission has been reviewing the impact of the TCJA on regulated utilities?

A. Yes, the Commission first ordered Missouri electrical corporations, gas corporations, and Missouri-American Water Company to provide estimates of the tax changes and how their rates would be affected in a working docket, File No. AW-2018-0174, on January 3, 2018.

Q. Did Empire respond to the Commission order?

A. Yes. With its *Response to Order* cover pleading Empire filed on January 31, 2018, a confidential Exhibit A in which it indicated that the tax rate change would cause excess earnings of approximately $17,837,022[5] for its electrical utility operations in Missouri. Empire did not file any estimate of the excess ADIT.

Q. When did you obtain information from Empire that would allow you to calculate an estimated total for excess ADIT?

A. The morning of Friday, July 6, 2018. Empire provided OPC with answers to OPC data requests late in the afternoon the day before. Emails that OPC obtained from Empire ~~is~~in discovery that are attached as Schedule JSR-D-3 indicate that Empire had been working on calculating excess ADIT since as far back as *October of 2017*. As far as I can tell, none of these estimates of excess ADIT were ever provided to the Commission in response to the order from AW-2018-0174 or the Commission's order to show cause in ER-2018-0228.

Q. Empire has filed testimony that argues that this case should be dismissed due to ~~an~~a dismissed case No. ER-2018-0228, filed by the Commission Staff. How do you respond?

[5] The response was marked confidential but income taxes are cost of service item within the Staff accounting schedules.

A. ER-2018-0228 was dismissed by the Commission on May 17, 2018, prior to the effective date of the statute, and therefore Empire's argument is misplaced. Empire has not voluntarily provided information to the Commission concerning excess ADIT or made any offers to settle its overearning. Contrary to its responses filed in ER-2018-0228 that indicated an inability to determine any protected or unprotected ADIT until the procurement of software, the attached emails indicate that the Company was working on these excess ADIT calculation even before the Commission made any directives. Empire would like for the provisions of SB 564 to be nullified so the overearnings from January 1 till the new rate go into effect can be dismissed.

It would appear that the Company is dragging its feet to cling to every dollar of excess earnings that it can. Maybe the Commission should consider a carrying charge to include in Empire's cost of service when a reduction is established.

Q. does this conclude your testimony?

A. Yes.