

**Exhibit No.:**

**Issue(s):** Net Operating Loss (NOL)

**Witness/Type of Exhibit:** Riley/Direct

**Sponsoring Party:** Public Counsel

**Case No.:** WR-2020-0344

**DIRECT TESTIMONY  
OF  
JOHN S. RILEY**

Submitted on Behalf of the Office of the Public Counsel

**MISSOURI-AMERICAN WATER COMPANY**

CASE NO. WR-2020-0344

November 24, 2020

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

In the Matter of Missouri-American )  
Water Company's Request for )  
Authority to Implement General Rate )      Case No. WR-2020-0344  
Increase for Water and Sewer Service )  
Provided in Missouri Service Areas )

**VERIFICATION OF JOHN S. RILEY**

John S. Riley, under penalty of perjury, states:

1. Attached hereto and made a part hereof for all purposes is my direct testimony in the above-captioned case.
2. My answer to each question in the attached direct testimony is true and correct to the best of my knowledge, information, and belief.

/s/ John S Riley

John S. Riley, C.P.A.  
Senior Utility Regulatory Auditor  
Office of the Public Counsel

**DIRECT TESTIMONY  
OF  
JOHN S RILEY**

**CASE NO. WR-2020-0344**

- 1           **Q. What is your name and what is your business address?**

2           A. John S. Riley, PO Box 2230, Jefferson City, Missouri 65102.

3           **Q. By whom are you employed and in what capacity?**

4           A. I am employed by the Missouri Office of the Public Counsel (“OPC”) as a Senior Utility

5           Auditor.

6           **Q. What is your educational background?**

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

8           University.

9           **Q. What is your professional work experience?**

10          A. I was employed by the OPC from 1987 to 1990 as a Public Utility Accountant. In this capacity,

11          I participated in rate cases and other regulatory proceedings before the Public Service

12          Commission (“Commission”). From 1994 to 2000 I was employed as an auditor with the

13          Missouri Department of Revenue. I was employed as an Accounting Specialist with the

14          Office of the State Court Administrator until 2013. In 2013, I accepted a position as the Court

15          Administrator for the 19<sup>th</sup> Judicial Circuit until April 2016 when I joined the OPC as a Public

16          Utility Accountant III. I have also prepared income tax returns, at a local accounting firm, for

17          individuals and small business from 2014 through 2017

18          **Q. Are you a Certified Public Accountant (“CPA”) licensed in the State of Missouri?**

19          A. Yes. As a CPA, I am required to continue my professional training by attending Missouri

20          State Board of Accountancy qualified educational seminars and classes. The State Board of

21          Accountancy requires that I spend a minimum of 40 hours a year in training that continues

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4 my education in the field of accountancy. I am also a member of the Institute of Internal  
5 Auditors (“IIA”) which provides its members with seminars and literature that assist CPAs  
6 with their annual educational requirements.

7 **Q. Have you previously filed testimony before the Missouri Public Service Commission?**

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

9 **Q. What is the purpose of your direct testimony?**

10 A. The purpose of my testimony is to address the treatment that the Commission should afford  
11 the “net operating losses” (“NOL”) reflected on Missouri American Water Company’s  
12 (“MAWC”) books. It is my conclusion that MAWC’s inclusion of an NOL in its calculations  
of rate base and revenue requirement for this case is inappropriate due to the income tax  
expense built into the case as well as a misapplication of the Internal Revenue Service (“IRS”)  
normalization rules.

13 **Q. What is the adjustment you are proposing?**

14 A. Company answer to OPC data request 1302, attached as JSR-D-2, indicates the NOL amount  
15 included in its revenue requirement is \$43.8 million for federal taxes and \$7.2 million for state  
16 taxes. Of these totals, the Company identified \$24.7 million as protected and \$26.3 million  
17 as unprotected. Because of several factors, I am recommending a total reduction of \$51  
18 million from the Company’s \$407 million baseline rate base.

19 **Q. Would you please summarize MAWC’s argument as to how the NOL affects these  
20 calculations?**

21 A. Under established rate making procedures, a company’s rate base is reduced by the deferred  
22 tax balance (“ADIT”) that has accumulated due to the difference between the regulatory  
23 depreciation balance used in ratemaking and the larger depreciation balance created by the  
24 use of accelerated depreciation methods employed for tax purposes. The ADIT balance is the

4 difference between the regulatory depreciation and the accelerated depreciation multiplied by  
5 the federal/state tax rate. MAWC is arguing that the NOL created by accelerated depreciation  
6 and other IRS tax advantage allowances should be applied as an offset to this ADIT rate base  
7 reduction.

8 As an example, let's assume a simplified rate base of \$100, an ADIT of \$5, and an NOL of  
9 \$1. The normal calculation is to reduce the \$100 rate base by the \$5 of ADIT yielding a final  
10 rate base of \$95 ( $\$100 - \$5 = \$95$ ). The Company asserts that the NOL of \$1 should reduce  
11 the ADIT so its calculation is the \$100 rate base less the \$4 that results from reducing the \$5  
12 ADIT by the \$1 NOL for a total final rate base of \$96 ( $\$100 - (\$5 - \$1) = \$96$ ).

13 **Q. Why is MAWC's position regarding the application of an NOL in this manner  
14 incorrect?**

15 A. ADIT is a tax benefit conferred on a utility by the federal government. It effectively functions  
16 as a form of interest free loan represented by the money the utility collects from ratepayers –  
17 ostensibly so it can pay income taxes – but then it does not actually remit as taxes.<sup>1</sup> MAWC  
18 is attempting to convince the Commission that its NOL, which is merely a tax return item  
19 used to reduce tax liability, somehow prevents the Company from making use of this interest  
20 free money. This is obviously false.

21 ADIT is already incorporated into the income tax expense that is itself included in MAWC's  
22 revenue requirement. The Company will consequently collect and have access to this interest  
free money regardless of any NOL it claims on its books. Moreover, it is inappropriate to try  
and offset ADIT with an NOL without taking into consideration the rest of MAWC's income  
tax expenses that should otherwise offset the NOL.

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<sup>1</sup> Does not remit as tax until the timing difference reverses.

4 **Q. What are you referring to when you mention “the rest of MAWC’s income tax  
5 expenses?”**

6 A. ADIT only makes up a part of MAWC’s total income tax expense to be included in MAWC’s  
7 revenue requirement. The remaining income tax expense, which Staff refers to as the “current  
8 income tax expense” can be thought of as the income tax the utility will still be expected to  
remit to the IRS even though it is using accelerated depreciation instead of straight line  
depreciation. However, even though this remaining income tax expense is included in  
MAWC’s revenue requirement, it still does not end up being paid as taxes.

9 **Q. How can it be that this remaining income tax expense is not being used to pay MAWC’s  
10 income taxes?**

11 A. MAWC does not pay current income taxes despite collecting income tax expenses from  
12 customers precisely because of the NOL that the Company is now relying on for its  
13 argument to reduce ADIT. This NOL is effectively used by MAWC to reduce its tax  
14 liability to zero and, as a result, MAWC has not paid a dime in federal taxes in over three  
15 years. This means that the current income tax expense included in MAWC’s revenue  
16 requirement is effectively also a source of interest free money for the Company.

17 **Q. So your basic argument is that the Company enjoys interest free money over and  
18 above the ADIT portion of its income tax expense due to the remaining portion of  
19 income tax expense that is not paid to the taxing authorities?**

20 A. Yes. Any NOL offset MAWC might claim would be completely negated by the current  
21 income tax portion of the income tax expense built into rates that exists independently of  
22 ADIT.

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4 **Q. What amount did Staff include as the current portion of income tax expense in the  
5 last general rate case for MAWC?**

6 A. For WR-2017-0285, Staff's initial accounting schedules included a current portion of  
7 income tax expense of \$21,681,560. So when that case was finalized, MAWC had the use  
of a similar amount each year. That is over \$60 million in interest free money over three  
years. That is more than enough to offset the \$53 million that the Company proposes to  
include as a reduction to ADIT.

8 **Q. What would be the result of allowing MAWC to reduce its ADIT by the claimed NOL  
9 without considering the remaining income tax expense?**

10 A. Right now, MAWC's revenue requirement will include income tax expense calculated as  
11 though MAWC were using straight-line depreciation method. When MAWC actually goes  
12 to remit its taxes to the IRS, however, it will calculate those taxes as though it were using  
13 accelerated depreciation thus leaving a sizable amount of the money that MAWC collected  
14 from ratepayers to cover its tax expenses in MAWC's possession. That amount of money  
15 represents the ADIT. At the same time, MAWC will employ its NOL to reduce the  
16 remaining portion of its tax liability to zero. Thus, MAWC will effectively retain all of the  
17 income expense included in rates for its own use. Because the NOL is already going to be  
18 used to reduce MAWC's remaining income tax liability to zero, allowing MAWC to also  
19 reduce the ADIT portion of its income tax expense by the same amount would effectively  
20 be double dipping. This should not be allowed.

21 **Q. In addition to arguing that MAWC's NOL adjustment was inappropriate due to the  
22 income tax expense built into the case, you had also mentioned in your opening  
23 statement that including the NOL was a misapplication of the normalization rule.  
24 Could you explain that statement?**

25 A. Yes. The IRS normalization rules only apply to items subject to accelerated depreciation.  
26 Expense items that are depreciated in ratemaking but are written off immediately for tax

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4 purposes are not required to be normalized. Company indicated in JSR-D-2 that \$26.3  
5 million of the proposed NOL deduction was attributable to unprotected (nonaccelerated  
6 depreciation items). Not recognizing this portion of the proposed NOL is not a violation  
7 of IRS rules.

8 I point this out due to the fact that MAWC has argued the presence of normalization  
9 violations in its last four ISRS cases. This argument does not apply to this unprotected  
10 NOL amount.

11 **Q. Could you summarize your argument for excluding the NOL adjustment from rate  
12 base?**

13 A. Yes. MAWC has argued in the past that the NOL must be recognized due to the  
14 Company's inability to utilize the interest free money created by the ADIT. This is wrong.  
15 The unspent income tax expense already included in MAWC's revenue requirement is  
more than enough interest free money to offset any NOL on the Company's books.

16 **Q. Does this conclude your direct testimony?**

17 A. Yes

**John S. Riley, CPA**  
**Summary of Case Participation**

ST LOUIS COUNTY WATER COMPANY	CASE NO. WR-88-5
SOUTHWESTERN BELL TELEPHONE COMPANY	CASE NO. TC-89-21
EMPIRE DISTRICT ELECTRIC COMPANY	CASE NO. ER-2016-0023
KCP&L GREATER MISSOURI OPERATIONS COMPANY	CASE NO. ER-2016-0156
KANSAS CITY POWER & LIGHT COMPANY	CASE NO. ER-2016-0285
AMEREN MISSOURI	CASE NO. ER-2016-0179
EMPIRE DISTRICT ELECTRIC PRUDENCE REVIEW	CASE NO. EO-2017-0065
LACLEDE GAS COMPANY	CASE NO. GR-2017-0215
MISSOURI AMERICAN WATER COMPANY	CASE NO. WU-2017-0351
MISSOURI AMERICAN WATER COMPANY	CASE NO. WR-2017-0285
LIBERTY (MIDSTATE NATURAL GAS)	CASE NO. GR-2018-0013
KANSAS CITY POWER AND LIGHT	CASE NO. ER-2018-0145
KCP&L GREATER MISSOURI OPERATIONS COMPANY	CASE NO. ER-2018-0146
EMPIRE DISTRICT ELECTRIC PRUDENCE REVIEW	CASE NO. EO-2018-0244
EMPIRE DISTRICT ELECTRIC COMPANY	CASE NO. ER-2018-0228
EMPIRE DISTRICT ELECTRIC COMPANY	CASE NO. ER-2018-0366
EMPIRE DISTRICT ELECTRIC COMPANY	CASE NO. EO-2018-0092
AMEREN GAS COMPANY	CASE NO. GR-2018-0227
MISSOURI AMERICAN WATER COMPANY	CASE NO. WO-2018-0373
LIBERTY UTILITIES EMPIRE ELECTRIC CO	CASE NO. EA-2019-0010
SUMMIT NATURAL GAS OF MISSOURI, INC	CASE NO. GR-2018-0230
SPIRE NATURAL GAS, EAST/WEST ISRS	CASE NO. GO-2019-0115
MISSOURI AMERICAN WATER COMPANY	CASE NO. WO-2019-0184

**John S. Riley, CPA**  
**Summary of Case Participation**

AMEREN GAS	CASE NO. GR-2019-0077
UNION ELECTRIC COMPANY	CASE NO. ER-2019-0335
LIBERTY EMPIRE ELECTRIC CO.	CASE NO. ER-2019-0374
MISSOURI AMERICAN WATER CO.	CASE NO.WO-2020-0190
EMPIRE ELECTRIC COMPANY FAC	CASE NO. ER-2020-0311

**DATA INFORMATION REQUEST**  
**Missouri-American Water Company**  
**WR-2020-0344**

**Requested From:** Brian LaGrand  
**Date Requested:** 8/26/2020

**Information Requested:**

NOL in rate base - Please provide the NOL balances that Company proposes to include in rate base for this case. Please break-out NOL by protected and unprotected balances. Also separate NOL into actual and future test year balances.

**Requested By:** John Riley - Office of Public Counsel – john.riley@opc.mo.gov

**Information Provided:**

The following table provides the gross NOLC outstanding as of 12/31/2019 used for year end tax provision purposes, which will be updated in a later filing when the tax return is completed. 2020 activity and balances will be provided in as scheduled to be updated.

A NOL DTA was not originally included in the ADIT balance used to compute rate base for this case, as it was prepared assumed the Company would be using a future test year in which the Company did not expect to be carrying an NOLC. Given a historic test year of 2019 updated for 2020 is now being used, it would be appropriate economically and pursuant to the tax normalization rules to include the NOLC DTA carried by the Company during the test year.

EADIT remains a component of ADIT included in rate base until normalized/amortized.

For the purpose of responding to this data request the Company used the with and without method to determine which portion of the NOLC balance is protected and which portion of the NOLC balance was unprotected. The DTA related to the Federal NOLC for historical test year of 12/31/2019 is \$20.9M of ADIT and \$22.8M of EADIT, of that \$24.7M is protected and \$19.1M is unprotected. The State NOL DTA is \$7.2M, which is all unprotected.

	<u>Gross</u>	<u>ADIT</u>	<u>EADIT</u>	<u>Total Regulatory ADIT</u>
<b>Federal NOL</b>	99,969,600	20,993,616	22,817,238	43,810,854
	<u>Protected</u>			
	68,746,758	14,436,819	10,293,171	24,729,990
	<u>Unprotected</u>			
	31,222,842	6,556,797	12,524,067	19,080,864
<b>State NOL</b>	<u>Unprotected</u>			
		2,069,616	5,166,647	7,236,263

Responsible Witness: John Wilde