

Exhibit No.:
Issue(s):
Witness/Type of Exhibit:
Sponsoring Party:
Case No.:

ISRS
Hyneman/Direct
Public Counsel
WO-2018-0059

DIRECT TESTIMONY

OF

CHARLES R. HYNEMAN

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WO-2018-0059

November 20, 2017

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

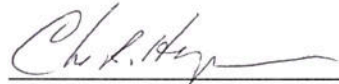
In the Matter of the Petition of)
Missouri-American Water Company for)
Approval to Establish an Infrastructure) Case No. WO-2018-0059
System Replacement Surcharge)

AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Charles R. Hyneman, of lawful age and being first duly sworn, deposes and states:

1. My name is Charles R. Hyneman. I am the Chief Public Utility Accountant for the Office of the Public Counsel.
2. Attached hereto and made a part hereof for all purposes is my direct testimony.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.




Charles R. Hyneman, C.P.A.
Chief Public Utility Accountant

Subscribed and sworn to me this 20th day of November 2017.



JERENE A. BUCKMAN
My Commission Expires
August 23, 2021
Cole County
Commission #13754037



Jerene A. Buckman
Notary Public

My Commission expires August 23, 2021.

DIRECT TESTIMONY
OF
CHARLES R. HYNEMAN
MISSOURI AMERICAN WATER COMPANY
CASE NO. WO-2018-0059

1 **Q. Please state your name and business address.**

2 A. Charles R. Hyneman, 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 the Chief Public
5 Utility Accountant.

6 **Q. Please describe your educational background.**

7 A. I earned an MBA from the University of Missouri - Columbia, and a BS in Accounting from
8 Indiana State University at Terre Haute, Indiana.

9 **Q. Please describe your professional work experience.**

10 I was a member of the Missouri Public Service Commission Staff (“Staff”) from April 1993
11 to December 2015. As a member of the Staff, I held various positions including Manager of
12 the Public Service Commission’s (“Commission”) Kansas City Office. I left the Staff holding
13 the position of Regulatory Auditor V, a senior-level professional and supervisory position
14 where I performed, supervised, and coordinated regulatory auditing work.

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

16 A. Yes. I am also a member of the American Institute of Certified Public Accountants
17 (“AICPA”).

1 **Q. Do you have significant experience performing and supervising audits of utility**
2 **Infrastructure System Replacement Surcharge (“ISRS”) petitions?**

3 A. Yes. As a member of Staff, I was involved in the development and implementation of Staff’s
4 policies and audit procedures on Infrastructure System Replacement Surcharge (“ISRS”)
5 petitions beginning in 2004. Since 2004 I have performed and supervised several ISRS audits
6 of Missouri Gas Energy (“MGE”), Laclede Gas Company (“Laclede Gas”), and Missouri
7 American Water Company (“MAWC”).

8 **Q. What is an ISRS?**

9 A. In 2003, the Legislature enacted Sections 393.1000 through 393.1006 of the Revised Missouri
10 Statutes ("ISRS statutes"). Those statutes allow for the use of a single-issue rate mechanism,
11 outside of a formal rate case, for a water corporation to recover the cost of utility plant projects
12 via a petition to establish or change an ISRS. The ISRS only includes the cost increases
13 associated with the plant projects and does not consider increases in revenues or decreases in
14 other costs that would offset the increased ISRS plant costs. The specific costs recovered
15 through an ISRS include capital costs (interest and profit) on the net ISRS rate base, income
16 taxes on the equity component of capital costs, depreciation expense, and property taxes.

17 **Q. Are ISRS revenues designed to recover a return on the net ISRS rate base, which reflects**
18 **that dollar amount of ISRS plant less accumulated deferred income taxes and**
19 **accumulated depreciation?**

20 A. Yes. However in this ISRS case, because MAWC is in a “net operating loss condition”, it
21 asserts that it is not able to recognize the accelerated tax depreciation deductions on this ISRS
22 plant to reduce its income tax expense as it has no net taxable income to reduce. As a result,
23 MAWC’s proposed ISRS rate base is higher than it should be because it did not include the
24 accumulated deferred income taxes that are normally included in an ISRS.

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

2 A. The purpose of this testimony is to support OPC's proposed adjustments to MAWC's ISRS
3 revenue requirement calculation included in its ISRS Application.

4 **Q. In your testimony, do you reach any legal conclusions or make any legal interpretations
5 of the ISRS statute or ISRS rule?**

6 A. No. My testimony is based on the language in the ISRS statute and ISRS rule that address
7 rate regulation, ratemaking principles, regulatory concepts, and rate case and ISRS regulatory
8 audits.

9 **Q. Then are you presenting an analysis of the regulatory principles, policies and practices
10 addressed by the ISRS statute and ISRS rule?**

11 A. Yes. I am basing my opinions on my education and significant experience with regulatory
12 concepts, principles, and policies and with past Commission ISRS cases and past rate cases.
13 My experience includes supervising and performing general rate case audits on a continuing
14 basis since 1993 and supervising and performing utility ISRS reviews on a continuing basis
15 since 2004.

16 **Q. What is the scope of an ISRS audit?**

17 A. An ISRS audit requires a review of the various ISRS costs such as plant work orders,
18 depreciation expense on ISRS plant, capital costs, deferred income taxes, income tax expense
19 and property taxes.

20 **Q. Did OPC conduct a full ISRS review in this case?**

21 A. No. Due to limited resources OPC limited its review to the areas of deferred income taxes,
22 income tax expense and earnings and equity-based management incentive compensation

charged to the proposed ISRS plant. Based on this limited review, OPC is proposing three adjustments to MAWC’s proposed amount of its ISRS.

Q. What is the OPC requesting the Commission do in this case?

A. OPC requests the Commission order its Staff to recalculate MAWC’s ISRS by excluding the ISRS revenue requirement dollar amounts reflected in OPC’s adjustments 1, 2 and 3 shown below:

	MAWC Total	Staff Total	OPC Total
ISRS Plant Additions	\$48,094,181	\$48,094,172	\$48,094,172
CIAC	(\$870,190)	(\$869,167)	(\$869,167)
Accumulated Deferred Income Taxes	\$685,873	(\$9,125,799)	\$0
Depreciation Reserve	(\$555,245)	(\$616,623)	(\$616,623)
Incentive Comp-earnings	\$0	\$0	(\$51,290)
Incentive Comp-equity	\$0	\$0	(\$7,536)
Reserved	\$0	\$0	\$0
Total	\$47,354,620	\$37,482,583	\$46,549,557
ROR (with & w/out inc taxes)	10.35%	10.35%	7.39%
Return on ISRS Rate Base	4,901,203	3,879,447	3,440,012
Depreciation Expense	627,750	627,750	627,750
Property Taxes	113,692	113,692	113,692
Subtotal	5,642,645	4,620,889	4,181,454
Amount from Previous ISRS	2,484,500	2,484,500	0
Total ISRS Revenue Requirement	8,127,145	7,105,389	4,181,454
		OPC v MAWC	OPC v Staff
Exclude costs from previous ISRS	Adjustment 1	(2,484,500)	(2,484,500)
Remove ADIT or Income Tax Expense	Adjustment 2	(\$1,456,844)	(\$435,088)
Remove capitalized earnings and equity-based incentive compensation	Adjustment 3	(\$4,347)	(\$4,347)
	Total	(\$3,945,691)	(\$2,923,935)

Q. Please explain OPC’s Adjustment 1, the exclusion of purported past ISRS costs from this ISRS application.

A. In the Commission’s *Order Granting Motion to Dismiss* in Case No. WO-2017-0297 the Commission dismissed MAWC’s ISRS petition, stating:

1 [a]s the Court of Appeals found, the Commission finds that the
2 county in which MAWC operates does not have more than one
3 million inhabitants based upon the 2010 census, as required by the
4 currently effective Section 393.1003.1. Therefore, **MAWC does**
5 **not qualify for an ISRS** under the express terms of Section
6 393.1003, and its petition must be dismissed. (Case No. WO-2017-
7 0297, Doc. No. 15, p. 5)
8

9 The Commission's decision granting OPC's motion to dismiss the company's ISRS
10 petition in WO-2017-0297 recognized the company did not meet the statutory requirements
11 prior to the effective date of H.C.S. H.B. 451. As such, the prior ISRS, which was
12 implemented at the time the 2010 census was effective, was also unauthorized and so there
13 is no accumulated balance to be reconciled.

14 Furthermore, any reconciliation amount that may have existed if the prior ISRS was
15 authorized was resolved in the company's prior rate case, WR-2015-0301. In that case, the
16 parties resolved a number of issues in a stipulation and agreement. From OPC's perspective,
17 the stipulation resolved the issue by eliminating the company's ISRS, including all
18 "reconciliation" amounts, but included the value of the infrastructure in-service in the
19 company's rates consistent with traditional ratemaking standards. For these reasons, the
20 Commission should exclude the purported reconciliation amount in this case.

21 **Q. Please explain OPC's Adjustment 2, the exclusion of income tax expense from MAWC's**
22 **proposed ISRS calculation**

23 A. In determining the amount of MAWC's surcharge for this case the Commission is restricted
24 in the types of expenses it can allow in MAWC's surcharge. Section 393.1000 (1)(b) states
25 that ISRS revenues (appropriate pretax revenues) are the revenues necessary to "recover"
26 state, federal and local income taxes applicable to the revenues generated by the ISRS.

27 OPC has determined that, based on MAWC's ability to apply its net operating loss ("NOL
28 carryforwards") tax credits to future taxable income, it will not pay any current income taxes

1 associated with any ISRS revenues recovered under this ISRS. In its ISRS Application
2 MAWC is proposing to charge its ratepayers for ISRS current income taxes that it will not
3 pay. This proposal is directly contrary to the ISRS statutes, Sections 393.1000 to 393.1006
4 and the Commission ISRS rule.

5 **Q. What is the definition of “recover”?**

6 A. According to Black’s Law Dictionary, Seventh Edition, page 1280, the definition of “recover”
7 is “to get back or regain in full or in equivalence.” Since Section 393.1000 (1)(b) states that
8 ISRS revenues are the revenues necessary to “recover” state, federal and local income taxes,
9 MAWC would have to actually “pay” income taxes in order to recover them back through the
10 ISRS. MAWC will not pay income taxes on the ISRS revenues generated in this ISRS and
11 therefore there are no income taxes for MAWC to recover under the ISRS.

12 **Q. Does Commission rule 4CSR 240-3.650(1)(A)(2) also state that ISRS revenues are the**
13 **revenues necessary to “recover” income taxes paid on ISRS income?**

14 A. Yes.

15 **Q. Are there other Sections of the ISRS statutes that restrict the Commission from**
16 **including nonexistent income taxes in an ISRS?**

17 A. Yes. Section 393.1006 (4)(1) states that in determining the appropriate pretax revenues, the
18 commission shall consider only the current state, federal, and local income or excise tax rates.
19 The current federal and state tax rate for MAWC for this ISRS is zero since MAWC has not
20 paid income taxes in several years and is not projected to pay income taxes on the revenues
21 generated by this ISRS.

22 **Q. How did you calculate the amount of income tax expense included in MAWC’s ISRS**
23 **Application?**

1 A. I simply used the agreed upon rate of return in MAWC's latest rate case and adjusted this
2 return to remove that portion of the return designed to recover income taxes on the equity
3 portion of the rate of return.

4 **Q. Please summarize the issue in this case.**

5 A. By ISRS statute, MAWC is required to include the amount of accumulated deferred income
6 taxes as a reduction to the ISRS rate base included in its ISRS application. MAWC did not
7 include this ISRS rate base reduction as required by the ISRS statute. MAWC asserts that
8 because it does not have taxable income to which to apply its accelerated tax depreciation
9 deductions, it does not have such deferred income taxes in which to reduce its ISRS rate base.

10 In spite of the fact that MAWC will have no net taxable income and will pay no income taxes
11 on these ISRS revenues, it still seeks to charge its customers for the taxes it will not pay in
12 this ISRS. MAWC's position is not only unreasonable and unfair to its ratepayers, it is not
13 consistent with the ISRS revenue requirement components required by the ISRS statutes.
14 OPC opposes MAWC from forcing its ratepayers to pay for a tax that it will not pay as a result
15 of these ISRS revenues.

16 **Q. Please explain OPC's Adjustment 3, the exclusion of the revenue requirement impact of**
17 **MAWC including earnings-based and equity based incentive compensation in its plant**
18 **in service amounts.**

19 A. Included in MAWC's proposed ISRS plant are dollars related to MAWC's income-based
20 incentive compensation and equity-based incentive compensation. Removing dollars related
21 to income-based incentive compensation and equity-based incentive compensation would be
22 consistent with the Commission's longstanding practice that these types of expense provide
23 no ratepayer benefit and therefore should not be included in a utility's cost of service.

1 **Q. Please summarize the Commission’s longstanding prohibition of allowing utilities to**
2 **charge Missouri ratepayers for earnings based and equity-based incentive**
3 **compensation.**

4 A. In its Report and Order in Case No. GR-96-285, a Missouri Gas Energy (“MGE”) case, the
5 Commission explained its policy that compensation not significantly driven by the interests
6 of ratepayers should not be included in a utility’s revenue requirement:

7 The Commission finds that the costs of MGE’s inventive
8 compensation program should not be included in MGE’s revenue
9 requirement because the incentive compensation program is driven at
10 least primarily, if not solely, by the goal of shareholder wealth
11 maximization, and it is not significantly driven by the interests of
12 ratepayers.
13

14 Approximately eight years later, the Commission reiterated and emphasized yet clarified its
15 position on rate recovery of utility incentive compensation in its Report and Order in Case
16 No. GR-2004-0209:

17 The Commission agrees with Staff and Public Counsel that the
18 financial incentive portions of the incentive compensation plan should
19 not be recovered in rates. Those financial incentives seek to reward
20 the company’s employees for making their best efforts to improve the
21 company’s bottom line. Improvements to the company’s bottom line
22 chiefly benefit the company’s shareholders not its ratepayers. Indeed,
23 some actions that might benefit a company’s bottom line, such as a
24 large rate increase, or the elimination of customer service personnel,
25 might have an adverse effect on ratepayers.
26

27 If the company wants to have an incentive compensation plan that
28 rewards its employees for achieving financial goals that chiefly benefit
29 shareholders, it is welcome to do so. However, the shareholders that
30 benefit from that plan should pay the cost of that plan. The portion of
31 the incentive compensation plan relating to the company’s financial
32 goals will be excluded from the company’s cost of service revenue
33 requirement.

1 In a 2006 Empire rate case, the Commission again restated its position on earnings-based
2 incentive compensation. In its Report and Order Upon Reconsideration in Case No. ER-2006-
3 0315, the Commission stated:

4 The Commission finds that the Staff reasonably applied objective
5 criteria for the exclusion of certain incentive compensation. The Staff
6 disallowed compensation related to charitable activities and activities
7 related to the provision of services other than retail electric
8 service...We conclude that incentive compensation for meeting
9 earnings goals, charitable activities, activities unrelated to the
10 provision of retail electric service, discretionary awards, and stock
11 options should not be recoverable in rates.
12

13 **Q. In addition to the cases cited, has the Commission expressed its prohibition of allowing**
14 **earnings-based and equity-based incentive compensation in other utility cases?**

15 A. Yes. The Commission has also applied and reiterated its position on earnings-based incentive
16 compensation in its Report and Orders in Case Nos. ER-2006-0314 and ER-2007-0291 - both
17 KCPL rate cases. There may be additional cases where the Commission expressed this policy
18 and the cases cited in this testimony are not intended to be all inclusive.

19 **Q. Does the ISRS statute or Commission's ISRS rule require the inclusion or exclusion of**
20 **any particular type of cost from the ISRS plant costs included in an ISRS Application?**

21 A. No. It is my understanding that the Commission has total discretion on what costs are included
22 and what costs are included in the utility plant balances sought to be recovered under an ISRS.
23 Therefore, it would be appropriate for this Commission to apply its longstanding policy of not
24 allowing ratepayers to be charged for executive compensation costs that provide no benefit to
25 ratepayers.

1 **Q. Please summarize OPC's recommendation on its ISRS Adjustment No. 3.**

2 A. To ensure that the Commission's policy is applied in this ISRS case, the capital costs
3 associated with \$51,290 of earnings-based incentive compensation and \$7,536 of equity-
4 based incentive compensation should be removed from MAWC's plant. These are the dollar
5 amounts attested to by MAWC in response to OPC data request 1001 that are included in the
6 proposed ISRS additions in this case. The ISRS revenue requirement impact of this
7 adjustment is a reduction of \$4,347.

8 **Q. Is OPC's proposal on the exclusion of this compensation in utility rates the exact same**
9 **position the Commission has taken over many years?**

10 A. Yes. There is no difference between the position OPC is recommending and the position the
11 Commission has traditionally taken on income and earnings-based incentive compensation
12 since at least 1996.

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

14 A. Yes.