

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

In the Matter of the Proposed Missouri-American) **File No. WT-2019-0054**
Water Company 2nd Revised Tariff Sheet No. R.65) Tracking No. JW-2019-0019

STAFF RECOMMENDATION

COMES NOW, Staff of the Missouri Public Service Commission (“Staff”), by and through counsel, and for its *Recommendation*, states as follows:

1. On Tuesday, August 21, 2018, Missouri-American Water Company (“MAWC” or “Company”) filed its P.S.C. Mo. No. 13, 2nd Revised Tariff Sheet No. R. 65 (2nd Revised R. 65) to replace the 1st Revised Tariff Sheet No. R. 65.

2. As a result, Staff sought a suspension of the 2nd Revised R. 65 for further proceedings before the Commission in its August 24, 2018, *Motion to Suspend Tariff*.

3. On September 5, 2018, the Commission issued its *Order Suspending Tariff, Directing Notice, Setting Intervention Deadline, and Directing Filing of Staff Recommendation (Order Directing Notice)*. That *Order Directing Notice*, set an intervention deadline of September 17, 2018, directed a Staff Recommendation regarding the tariff filing of October 5, 2018, and suspended the proposed tariff until November 7, 2018.

4. Staff filed its *Motion for Additional Notice and Request to Extend all Deadlines* on September 11, 2018, recommending that the Commission provide additional notice of this matter to the participants in the last MAWC rate case, Case No. WR-2017-0285, and to further extend the deadlines of intervention, the Staff Recommendation, and suspension of the tariff by 30 days each to accommodate the possibility of more intervenors.

5. Staff has reviewed the MAWC's amendments to its Taxable Advances and Contributions in Aid of Construction ("CIAC") tariff and after determined and careful review Staff recommends approval of the tariff sheet contained in JW-2019-0019. However, as more thoroughly explained in the Memorandum attached hereto as Appendix A, the deferral of CIAC income tax impacts, as contemplated in the tariff, should only be authorized to continue until such time as new rates go into effect from MAWC's next general rate case proceeding. Whether deferral treatment for the financial impact of CIAC donation income taxes should continue beyond that rate case should be addressed in that proceeding.

WHEREFORE, Staff respectfully requests that the Commission issue an order:

- A. Approving P.S.C. Mo. No. 13, 2nd Revised Tariff Sheet No. R. 65 to replace the 1st Revised Tariff Sheet No. R. 65;
- B. Directing MAWC to file an amended Taxable Advances and Contributions in Aid of Construction tariff in its next general rate case; and
- C. Any further relief the Commission deems just and reasonable.

Respectfully submitted,

/s/ Mark Johnson

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile, or electronically mailed to all parties and or counsel of record on this 5th day of November, 2018.

/s/ Mark Johnson

MEMORANDUM

To: Missouri Public Service Commission Official Case File, File No. WT-2019-0054,
Tariff File No. JW-2019-0019

From: Mark Oligschlaeger – Utility Regulatory Manager, Auditing Department,
Jim Busch – Utility Regulatory Manager, Water and Sewer Department

/s/ Natelle Dietrich 11/5/2018
Commission Staff/Date

/s/ Mark Johnson 11/5/2018
Staff Counsel's Office/Date

Subject: Staff Recommendation for the **Approval** of Missouri-American Water Company's P.S.C. Mo. No. 13, 2nd Revised Tariff Sheet No. R. 65 to replace the 1st Revised Tariff Sheet No. R. 65.

Date: 11/5/2018

On August 21, 2018, Missouri-American Water Company (MAWC) filed its P.S.C. Mo. No. 13, 2nd Revised Tariff Sheet No. R. 65 (2nd Revised R. 65) to replace the 1st Revised Tariff Sheet No. R. 65, Tracking No. JW-2019-0019. The 2nd Revised R. 65 proposes to alter how MAWC will account for income taxes that accrue from Contributions in Aid of Construction (CIAC) received by the Company. More particularly, the 2nd Revised R. 65 proposes that:

Any Federal, State or Local income tax incurred by the Company due to the receipt of taxable Advances or Contributions in Aid of Construction, as defined by the Internal Revenue Service, the State of Missouri, or other taxing authority, and not otherwise paid by a third party, will be paid by the Company. Such income taxes shall be segregated in a deferred account for inclusion in rate base in the Company's next general rate proceeding.

On August 24, 2018, Staff recommended that the Commission suspend the operation of this tariff and conduct further proceedings to determine whether to adopt or reject the proposed tariff. Staff recommends approval of the tariff sheet filed as Tracking No. JW-2019-0019. After Staff's September 11, 2018, *Motion for Additional Notice and Request to Extend all Deadlines*, the Commission further suspended MAWC's tariff until December 7, 2018, and ordered Staff to file a recommendation no later than November 5, 2018.

Staff is generally supportive of the **modifications** to the Company's Taxable Advances and CIAC policy as contained in 2nd Revised Tariff Sheet No. R. 65, however, the deferral of CIAC income tax impacts described in the tariff should only be authorized to continue until such

time as new rates go into effect from MAWC's next general rate case proceeding. Whether deferral treatment for the financial impact of CIAC donation income taxes should continue beyond that rate case should be addressed in that proceeding.

Analysis

Housing developers frequently construct water and sewer infrastructure as part of the construction process for new houses and subdivisions. When homeowners purchase the houses, the cost of the water and sewer infrastructure necessary to provide the residence with utility service is recovered as part of the overall price of the home. If a regulated water or sewer utility then provides service to the new homes, the water or sewer infrastructure already paid for by individual homeowners is "donated" to the water or sewer utility as a contribution-in-aid-of-construction (CIAC). Such donations are beneficial to the general body of water and sewer ratepayers as CIAC is treated as an offset to rate base for ratemaking purposes, thereby lowering the overall return amount on utility assets required from customers.

Donations of property to water and sewer utilities by developers have certain income tax consequences. For regulatory accounting purposes, the financial gain to the utility from the property donation is generally recognized ratably as an increase to net income over the estimated useful life of the donated property. However, for income tax purposes, under the provisions of the Tax Cuts and Jobs Act, the gain to the utility is recognized in full upon receipt of the donated property.¹ This varying financial reporting/tax treatment creates a "tax timing difference" (TTD). If the CIAC gain is assigned to the utility for income tax ratemaking purposes, and this TTD is provided tax normalization treatment by a regulatory commission, then a deferred tax asset would be created as an addition to utility rate base. The deferred tax asset will then be reversed over the estimated useful life of the contributed property.

Treatment of Income Tax Consequences of Donated CIAC

Staff is aware of two general approaches used in other jurisdictions to account for the income tax consequences of donated CIAC property. One is to assign the gain to the utility in the manner described above, which results in the general body of utility customers ultimately

¹ Prior to the Tax Cuts and Jobs Act, water and sewer companies had a tax exemption related to CIAC that was not available to energy and telephone utilities (i.e., CIAC was not treated as taxable income by water and sewer utilities). That exemption no longer exists.

paying the additional income taxes associated with the CIAC gain. The alternative approach is to allow the utility to recover the taxes from the developers directly through a surcharge, thus ultimately making the homeowners purchasing new residences responsible for this tax amount. Both approaches have reasonable arguments for and against their use.

The primary advantage of charging CIAC income taxes to the developers is that it is consistent with the concept of cost causation. Cost causation is the principle that the entity or group of customers that is causing the cost should be the responsible party for paying that cost. In this case, the additional tax impact on the company directly results from infrastructure donated to the utility in order for developers to sell lots and houses. No other customer is causing the increase of cost, and under the principles of cost causation those other customers should not be responsible for those costs. Another advantage of charging CIAC income taxes to developers directly is that it eliminates the need to determine which rate payers actually pay the increased tax. By allowing the utility to charge the entire body of ratepayers, at the time of ratemaking, the Commission will have to determine exactly which customer classes will be responsible for the tax, or how to fairly apportion the tax to the various customer classes. This additional consideration could add complexity to an already complicated case.

One perceived disadvantage of the approach of charging CIAC income taxes to developers is that such a course of action is inconsistent with “economic development”. By effectively raising the cost of developing new housing, and ultimately that of home ownership, the developer surcharge approach can be thought to impede otherwise beneficial economic activities. This approach could encourage economic development only in those areas not served by MAWC. Under this reasoning, charging CIAC taxes to utility ratepayers as a whole would be a more appropriate option.

At this time, Staff supports the approach of charging income tax amounts associated with CIAC to the general body of water and sewer ratepayers. One reason for this position is the economic development rationale for this approach as discussed above. Also, Staff takes this position as an accurate reflection of current federal income tax policy. The Tax Cuts and Jobs Act clearly designates water and sewer utilities as the parties from which such CIAC-related tax amounts are due. In almost all cases, the policy of this Commission has been to reflect income tax expense levied on utilities in customer rates that result from activities that are part of the

utility mandate to provide utility service to customers within their service territories. This criterion applies to income taxes due to the government due to CIAC donations. Finally, as discussed above, utility customers receive an overall rate benefit from developer donations of water and sewer infrastructure at zero capital cost. Given this benefit, charging the general body of ratepayers for the income tax consequences of developer donations would seem to be reasonable.

Staff supports the approach set forth in MAWC's filed tariff regarding treatment of CIAC in this case as being appropriate. However, the deferral of CIAC income tax impacts described in the tariff should only be authorized to continue until such time as new rates go in effect from MAWC's next general rate case proceeding. Whether deferral treatment for the financial impact of CIAC donation income taxes should continue beyond that rate case should be addressed in that proceeding.

Recommendation

At this time Staff recommends the Commission enter an order (1) approving the tariff sheet contained in Tracking No. JW-2019-0019, and (2) ordering MAWC to file an amended Taxable Advances and Contributions in Aid of Construction tariff, reflected here as P.S.C. Mo. No. 13, 2nd Revised Tariff Sheet No. R. 65 to replace the 1st Revised Tariff Sheet No. R. 65, in its next general rate case.

