

**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 System Replacement Surcharge) **Case No. WO-2019-0184**

**THE MISSOURI OFFICE OF THE PUBLIC
COUNSEL’S POST-HEARING BRIEF**

COMES NOW the Office of the Public Counsel (OPC or Public Counsel), by and through counsel, and for its Post-Hearing Brief states as follows:

BACKGROUND

On February 20, 2019, pursuant to Commission Rule 4 CSR 240-3.650, Missouri American Water Company (MAWC or Company), filed its Petition to Establish an Infrastructure System Replacement Surcharge & Motion for Approval of Customer Notice (Petition or Application). In its Application, the Company asked the Commission to adjust its Infrastructure System Replacement Surcharge (ISRS) under Section 393.1000 RSMo (2016). MAWC *Application* p. 2.

This February 20 *Application* is the second ISRS *Application* and *Petition* the Company has filed since its last rate case. MAWC proposes to collect a surcharge from its customers for infrastructure replacements or relocations eligible for ISRS recognition it made during the time period October 1, 2018 through March 31, 2019. MAWC also asked “to recover all state, federal and local income or excise taxes applicable to such ISRS income and to recover all other ISRS costs such as depreciation expense and property taxes due within 12 months of this filing.”

Pursuant to the Commission’s February 20, 2019 *Order Directing Notice, Setting Intervention Deadline and Directing Filing, And Suspending Tariff*, on April 22, the Staff of the Missouri Public Service Commission (Staff) filed its *Staff Recommendation* in which it raised

several concerns with the filing. More specifically the Staff discovered various costs that were charged to ISRS eligible projects that did not meet ISRS requirements including: repairs to customer owned appliances and property of \$1,295; and charges associated with service lines of \$3,278 and \$2,793 that was included in the prior ISRS case. In addition, Staff removed “MAWC’s hypothetical net operating loss, totaling \$8,850,970, from its calculation of the ISRS revenue requirement.” Staff memorandum p. 4 of 6. In its Memorandum Staff also notes:

[MAWC] has . . . used [the NOL] to offset the deferred tax liability related to this ISRS investment. As of this date, Staff’s understanding is that no amount of net NOL has actually been generated for income tax purposes by MAWC on an aggregate basis since October 1, 2018, (the beginning of this ISRS period). Alternatively, Staff has not been presented with any evidence that imputation of a “hypothetical” NOL amount into ISRS rate base in this case is required to comply with the normalization provisions of the Internal Revenue Service Code.

Staff Memorandum, p. 4 of 6. (emphasis added)

The Company’s April 26, 2019 *Response to Staff Recommendation*, notified the Commission “that it disagrees with Staff’s recommended increase in ISRS revenues. In particular, MAWC objects to Staff’s treatment of net operating losses (“NOLs”).” MAWC Response to Staff Recommendation p.1, para.3.

FACTS

1. On February 20, 2019, MAWC filed its *Petition* (also referred to as *Application*) seeking Commission authorization under Section 393.1000 RSMo (2016) to change the surcharge it currently charges its customers for certain infrastructure investments the Company has made during the period of October 1, 2018 through March 31, 2019.

2. The ISRS Statutes and the PSC ISRS rule require a water corporation to file a petition with the PSC that includes the company’s proposed rate schedules and the company’s supporting documentation. Sections 393.1012 and 393.1015 RSMo; 4 CSR 240-3.265(20).

The PSC is required to conduct an examination of the proposed ISRS to confirm compliance with the ISRS Statute. The PSC's Staff "may submit a report of its examination findings no later than sixty days after the petition is filed."

3. An ISRS proceeding is a statutorily authorized, single-issue, time specific, ratemaking. Exh. 12, Riley Reb. 2:22-23.

4. This is the second ISRS filing since the Company's most recent general rate case, which was Case No. WR-2017-0285.

5. In its *Application*, MAWC explained that it, "seeks to change its ISRS rate to provide for recovery of costs for infrastructure system replacements and relocations eligible for ISRS recognition." MAWC *Application* at p. 2, para 4.

6. The Company also included rate schedules it claimed as the appropriate pre-tax ISRS revenues necessary to produce net operating income equal to MAWC's weighted cost of capital multiplied by the net original cost of the requested infrastructure replacements that are eligible for the ISRS, including recognition of net accumulated deferred income taxes and accumulated depreciation associated with the aforesaid infrastructure system replacements." MAWC *Application* at p. 2-3, para 4.

7. On February 22, 2019, the Commission issued its Order Directing Notice, Setting Intervention Deadline, Directing Filing, and *Suspending Tariff*.

8. On April 22, 2019, the Staff of the Commission (Staff) filed its Recommendation in the form of a Memorandum, in which it concluded the Commission should issue an Order that: "(1) rejects MAWC's ISRS tariff sheet (YW-2019-0160), P.S.C MO No. 13 11th Revised Sheet No. RT 10 cancelling 10th Revised Sheet No. RT 10, filed on February 20, 2019; (2) approves the Staff's recommended ISRS surcharge revenues in the incremental pre-tax revenue amount of

\$8,878,845; and (3) directs that MAWC in future ISRS filings provide Staff with actual supporting documentation for previously estimated ISRS investment a minimum of two weeks prior to Staff's recommendation filing date." Staff's April 22 2019 *Memorandum* at p. 6 of 6.

9. On April 26, MAWC filed a Response to Staff's Recommendation accepting the Staff's recommendations except that it "hereby notifies the Commission that it disagrees with Staff's recommended increase in IRSR revenues. In particular, MAWC disagrees with Staff's treatment of net operating losses (NOLs). MAWC's Response at p 1: para 3.

8. On May 17, the Commission held an evidentiary hearing at which six witnesses testified, including Mr. John Riley, CPA, on behalf of the Office of the Public Counsel.

Introduction

Similar to the 2018 MAWC ISRS, the Company's claim of a Net Operating Loss (NOL) is the contested issue. OPC does not question any of Staff's calculations, and agrees with the Staff's treatment of NOL. No party opposed Staff's rate design calculations.

"First and foremost, an NOL is a tax return adjustment not a regulatory item. Specifically, an NOL is an accounting fiction where, for income tax purposes, a company reports deductions that are higher than reported revenues. This is an item the Company recognizes on its tax return as a taxable income loss. Typically, however, a regulated utility does not incur losses in its regular course of business. Income tax losses are a result of generous deductions allowed by the IRS." Exh. 11, Riley Direct p. 3: 15-31

An income tax loss, otherwise referred to as an NOL, is an income tax return generated event. An income tax reportable loss occurs when a corporation's consolidated tax deductions surpasses the taxable income included on its annual income tax return. American Water Works ("AWW") can only claim an NOL upon completion and filing of its consolidated federal or state

income tax return. On behalf of the consolidated companies, AWW will file its 2018 federal income tax return in September 2019. Until that time, AWW has not reported any income tax generated event. Stated another way, AWW has not filed with the IRS a return that shows any income or expenses that correspond to the ISRS timeframe at issue, meaning that MAWC cannot demonstrate an NOL occurred during this period. Exh. 13, Riley Reb. p. 2:7-16.

ARGUMENT

The parties agree that the only issue submitted for Commission decision is:

In determining MAWC's ISRS rates in this case, under the applicable statute, may MAWC's accumulated deferred income tax (ADIT) balance in rate base be reduced by the ADIT asset resulting from its net operating loss(es), if any?

Public Counsel's response is no, it cannot. The Net Operating Loss (NOL) MAWC proposes to use in this case is unrelated to the ISRS infrastructure MAWC installed during the ISRS period MAWC claims in this case. Testifying on behalf of Public Counsel, Mr. John Riley, CPA, explains: "Staff removed the \$8,850,970 NOL due to it being an unsubstantiated calculation. The timeframe for this ISRS period is October 1, 2018 through January 31, 2019 with true up ending March 31, 2019. Essentially, Staff's argument is that there is no actual NOL that can be associated to the ISRS timeframe due to the Company not generating an income tax loss in that period. The Staff does not accept a "hypothetical" NOL applied to the ISRS investment. To quote Staff's Revenue Calculation Section, point number 4 in its Memorandum:

Removal of MAWC's proposed net operating loss ("NOV") of \$8,850,970 that has been used to offset the deferred tax liability related to this ISRS investment. As of this date, Staff's understanding is that no amount of net NOL has actually been generated for income tax purposes by MAWC on an aggregate basis since October 1, 2018, (the beginning of this ISRS period). Alternatively, Staff has not been presented with any evidence that imputation of a "hypothetical" NOL amount into ISRS rate base in this case is required to comply with the normalization provisions of the Internal Revenue Service Code.

Exh. 11, Riley Dir. P.3:5-20.

Mr. Riley further explained: A Net Operating Loss (NOL), as a tax return item, has nothing to do with the Company's infrastructure or plant. As a result, an NOL has no connection to the Infrastructure System Replacement Surcharge. Exh. 11, Riley Dir, 4:2-4.

As the proponent of a change in rates, the Company has the Burden of Proof.

The Company cannot prove it actually has a NOL or Net Operating Loss Carryforward (NOLC) associated with eligible infrastructure replacements for the ISRS period starting January 1, 2018, because MAWC has not filed its 2018 tax return. Company witness John Wilde testified it will file on October 15, 2019. TR. Vol.2, p. 42:21-25. Nor can the Company prove that any NOL is specifically related to the infrastructure the Company claimed as ISRS eligible. Importantly, the Company, as the proponent of this rate change cannot meet its burden of proof. "Section 393.150 gives the Commission the authority to conduct a hearing regarding the propriety of new rates filed by any water corporation and to make a decision regarding those rates. Section 393.150.2 places the burden of proving that an increased rate is just and reasonable on the public utility. And all charges made or demanded 'shall be just and reasonable and not more than allowed by law.' "

Similarly, Section 393.1006 gives the Commission the authority to conduct a hearing on an ISRS Petition: "The commission may hold a hearing on the petition and any associated rate schedules and shall issue an order to become effective not later than one hundred twenty days after the petition is filed." Section 393.1006 RSMo (2016). Only if "the commission finds that a petition complies with the requirements of sections 393.1000 to 393.1006, [shall] the commission . . . enter an order authorizing the **water** corporation to impose an ISRS that is sufficient to recover appropriate pretax revenues, as determined by the commission pursuant to the provisions of sections 393.1000 to 393.1006.

For the Commission to approve inclusion of an NOL in this case MAWC would need to demonstrate there is an NOL associated with the infrastructure claimed as ISRS-eligible in this particular ISRS period. Section 393.1000(1)(a), RSMo,¹ defines “Appropriate Pretax Revenues” as:

[T]he revenues necessary to produce net operating income equal to: (a) The water corporation’s weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and depreciation **associated** with eligible infrastructure system replacements which are included in a currently effective ISRS.

(emphasis added).

The evidence in this case fully supports a finding that MAWC has not and will not have an NOL in 2018 that is “associated with eligible infrastructure” in this ISRS period. MAWC witness, John R. Wilde, at the hearing of the 2018 case WO-2018-0373 admitted that an NOL is not asset specific. Mr. Wilde was asked the direct question: “An NOL is not attached to any certain infrastructure, any particular asset?” Mr. Wilde answered: You’re correct with that.” Tr. Vol. 1, 52:16-18. With that response, Mr. Wilde agreed with Public Counsel’s testimony the NOL is not asset specific. This leads to the conclusion the NOL has no relationship to the ISRS infrastructure assets for which MAWC seeks recovery in this case. There was no redirect regarding Mr. Wilde’s response. TR. Vol. 1. 69:6 -73:3.

In his testimony in this 2019 case when asked “are the amounts that will ultimately be . . . sent to the IRS in . . . [MAWC’s 2018 federal tax filing] known as of today?” Mr. Wilde straightforwardly stated that any 2018 NOL is “knowable,” but is not yet known because the parent company AWW has not yet completed its 2018 tax return, due on October 15, 2019. Tr. Vol. 2,

¹ Commission Rule 4 CSR 240-3.650(1) outlines the identical requirements.

p.1:1-5. Mr. Wilde's testimony is not helpful to the Company's attempt to prove a 2018 NOL actually exists.

Finally, the Internal Revenue Service (IRS) Private Letter Rulings (PLR) attached to Mr. Wilde's testimony are equally unpersuasive. The PLRs Mr. Wilde attached are just that - Private rulings directed to a very specific question with specific facts. The taxpayer submits certain facts for the IRS to consider. The PLRs Mr. Wilde attached to his testimony are not applicable to the Company's situation in this case. The PLRs address general rate case proceedings and formula rate case proceedings. Tr. Vol. 2 99:12-17. When counsel for MAWC asked Staff witness Mr. Oligschlaeger whether he had "performed any independent research to see if there is a private letter ruling on this issue in the contest of a single issue ratemaking proceeding?" Mr. Oligschlaeger correctly replied that it is the Company's responsibility to produce sufficient evidence in this case: "I would expect the Company to produce that if such a thing existed." Tr. Vol 2, 99:21-22. In regard to IRS PLRs Mr. Oligschlaeger also testifies; "Part of the standard language in every PLR is it's not to be taken as precedential for other situations." Tr. Vol. 2 p. 101:5-6.

Mr. Wilde's "evidence" the Company will have a 2018 NOL by including a single pro forma document fails in many respects: (a) this is a pro forma document (b) neither this document or this amount of claimed NOL will appear in American Water Works (AWW) consolidated 2018 tax return, and (c) AWW will not file its federal income tax return for 2018 until October 15, 2019. These flaws prevent this single piece of paper from being even close to competent and substantial evidence.

This position is fully supported by Staff witness Mark Oligschlaeger, who testifies that the Company has not had any NOL costs that would have occurred during the ISRS period of October 1, 2018 to January 1, 2019. "*Only costs directly associated with qualifying ISRS plant that became*

in-service during those six months should be reflected in ISRS rates resulting from this proceeding.” Exh. 3, Oligschlaeger Direct, 6:16-23(emphasis added).

Mr. Oligschlaeger explains that MAWC is proposing “to use prior booked amounts of NOL as carry-forwards to offset taxable income in 2018 and 2019.” Mr. Oligschlaeger further clarifies: “[i]n other words, MAWC is no longer ‘generating’ an NOL [in 2018]; it is instead in the position of “using” the NOL booked in *prior* years to reduce future taxable income.” Exh.8, Oligschlaeger Direct, 7:1-8. During the hearing in further support of Staff’s position MAWC has not generated any NOL during this ISRS period Mr. Oligschlaeger testified: Since January of 2018 they [MAWC] have not generated any additional net operating loss.” Tr. Vol. 2, 69:17-18.

Public Counsel’s expert witness John Riley, in addressing the issue of whether MAWC had generated any NOL associated with this ISRS period, testified that to his knowledge MAWC had not had any NOL in 2018 or 2019. Instead, the Company will be applying prior years (2017) “NOLs to this ISRS calculation.” Exh. 11, Riley Dir. 5:5-13. In support of his position, Mr. Riley referred to Staff’s data request (DR) directed to the Company and attached as JSR-D-2. In response to Staff’s DR question: “Is MAWC currently expected to generate additional NOL amounts in 2018 and 2019 on an aggregate basis, or to use prior NOLs to offset taxable income in 2018 and 2019 in the aggregate? Please provide the projected net NOL amount generated or used for both calendar years.” JSR-D-2.

MAWC’s response led to Mr. Riley’s conclusion that there was no NOL associated with this current ISRS period. The Company response is: “MAWC expects to use prior NOLs in both 2018 and 2019 because it is part of AWW consolidated group which projects taxable income for those tax years. AWW projects to use approximately \$395million in 2018, per the year end provision estimate. MAWC was allocated about \$60.6 million, which, then tax effected, reduced

the deferred tax asset by approximately \$12 million." (See MoPSC 0006 Attachment Update). AWW projects to use approximately \$320 million in NOL in 2019." *Id.*

Logically, the fact that any MAWC-generated NOL is comingled with all of AWW's consolidated groups' NOLs, means any amount AWW generally allocated to MAWC could not be directly tied to any MAWC-specific asset.

In his Rebuttal Testimony on page 2 at lines 7-16, Mr. Riley further explains:

An income tax loss, otherwise referred to as an NOL, is an **income tax return generated event**. An income tax reportable loss occurs when a corporation's consolidated tax deductions surpasses the taxable income included on its annual income tax return. American Water Works ("AWW") can only claim an NOL upon completion and filing of its consolidated federal or state income tax return. On behalf of the consolidated companies, AWW will file its 2018 federal income tax return in September 2019. Until that time, AWW has not reported any income tax generated event. Stated another way, AWW has not filed with the IRS a return that shows any income or expenses that correspond to the ISRS timeframe at issue, meaning that MAWC cannot demonstrate an NOL occurred during this period.

Exh. 12, Riley Reb. 2:7-16 (emphasis in original).

The Commission addressed the lack of evidence in MAWC's 2018 ISRS case WO-2018-0373, and the Commission's conclusions are equally applicable here:

MAWC has not provided evidence to support that it will in fact have an NOL in 2018. On the contrary, the evidence indicates MAWC is generating more revenue for 2018 than it is generating expenses that qualify for deductions. Thus, MAWC is expected to utilize prior NOL carryovers to offset its taxable income in 2018 and 2019, but will not generate a new NOL. Since the IRS Private Letter Rulings only address periods where an NOL is generated, there is no legal support for MAWC's position that an exclusion of an NOL would violate normalization requirements of the IRS Code.

Because MAWC is expected to have taxable income in 2018, it is reasonable to conclude that MAWC is not generating an NOL during the 2018 ISRS Period at issue, either. And in fact, there was no evidence of an NOL being generated during the 2018 ISRS Period. In short, although the ISRS statute requires

recognition of ADIT, which might include reflection of an NOL, we cannot allow MAWC to reduce its ADIT balance to reflect an NOL that does not exist.²

MAWC has failed to prove there is any IRS Normalization violation.

Public Counsel will not repeat its comments regarding the IRS PLRs Mr. Wilde submitted as attachments to his Direct Testimony, Exh 1. MAWC is just now in the process of seeking an IRS PLR asking for an IRS ruling on whether it has a normalization violation under IRS rules. Counsel for MAWC indicated that “certainly there is a private letter ruling process that is underway.” Tr. Vol. 2 9-17. In his Direct Testimony Mr. Wilde states that it is in the process of working with Commission Staff to complete its PLR request and estimates it will take up to six months for the IRS to reply to MAWC’s submitted request. Exh.1, Wilde Dir. 11.

It would be premature for the Commission to make any determination on a potential IRS normalization violation, when the question has or will soon be presented to the very agency with responsibility and the expertise to interpret its own rules and to make such a determination.

The Company has suggested dire consequences. In his Direct Testimony Mr. Wilde in answering the question: “If the Company loses accelerated depreciation due to an incurable normalization violation, is that change permanent?” replies “Yes” and that the only cure he is aware of is a “federal legislative exception.” Exh 1, Wilde Dir. p. 12:22-24. On page 13 of his Direct, however, Mr. Wilde describes situations which occurred “in the late 1970’s” and how they were cured. At this point, there is no way to know whether MAWC might be found to have violated the IRS normalization rules, since

MAWC’s theory that it is generating NOL because it has paid to install the infrastructure claimed in this ISRS case and customers have not yet paid for this investment is not supported by the facts.

² Case No. WO-2018-0373, *In the Matter of the Petition of Missouri-American Water Company for Approval to Establish an Infrastructure Replacement Surcharge (ISRS)*, WO-2018-0373, issued December 5, 2018, pg. 8.

MAWC's curious theory that it is currently in an NOL position because it has installed infrastructure for which customers have not yet paid fails in several respects. Tr. Vol.2, 81:5-7. The idea the company is in a **net** operating loss situation because it has installed infrastructure during this ISRS time period and customers are not yet paying for it was quickly shot down by Staff. Tr. Vol. 2 p. 81:5-86:8.

Staff witness Mr. Oligschlaeger, under persistent cross-examination, maintained that the Company, which recently had a general rate case, WR-2017-0285, is presumed to be recovering from its ratepayers an adequate amount of revenue to cover its expenses and at least some level of return on its investments. Staff witness Oligschlaeger explained that a utility, whose rates have been set as just and reasonable by the Commission, is presumed to collect sufficient amounts to cover costs and at least some level of profit:

The normal accounting and ratemaking conventions are is that a utility collects rates from customers amounts to cover its cost and hopefully to earn a reasonable profit. As long as a utility is earning a positive rate of return, positive return on equity, again for accounting and ratemaking purposes it is assuming they are fully recovering all costs on their books.

Now, their equity -- return on equity in particular may be viewed to be too low or too high and that may trigger a rate action, but in almost all instances there's no question that a company is recovering its expenses from customers on an ongoing basis even without new rates.

Tr. Vol. 2, p. 81:11-23.

In response to the question: "But you believe [the Company] is getting recovery of its investment in the current ISRS filing] somehow through their base rates that were established in a general rate case. Right? Mr. Oligschlaeger further testified "Well, they [MAWC] are getting a recovery of costs and again hopefully some return through ongoing payments by customers in rates. While the return on equity may fluctuate over time based on new costs that a company incurs,

it is still assumed for fundamental accounting and ratemaking purposes that the Company is recovering all of the costs on its books.” Tr. Vol. 2, p. 82:4-12. Mr. Oligschlaeger persisted:

A. “Well again, I disagree with the premise that customers are not paying for income taxes on new ISRS plant additions right now as we speak.” Tr. Vol. 2, p. 83:24 – 84:1. .

Counsel for the Company was unable to sway Mr. Oligschlaeger and get him to agree with MAWC’s theory that MAWC, because it has paid for the ISRS plant for which it seeks recovery in this case, and customers have not repaid the Company, is in an NOL situation. Mr. Oligschlaeger and Staff held firm in their disagreement with the Company’s stratagem. Tr. Vol. 2, p.86:1-5

CONCLUSION

For the reasons stated above in Public Counsel’s Brief and OPC’s Exhibits and Testimony in this case, the Commission should issue its Order: (1) rejecting MAWC’s ISRS tariff sheet (YW-2019-0160) P.S.C MO No. 13 11th Revised Sheet No. RT 10 cancelling 10th Revised Sheet No. RT 10 filed on February 20, 2019; (2) approving Staff’s recommended ISRS surcharge revenues in this docket in the incremental pre-tax revenue amount of \$8,878,845; and (3) directing MAWC, in future ISRS filings to provide Staff with actual supporting documentation for previously estimated ISRS investment a minimum of two weeks prior to Staff’s recommendation filing date.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the forgoing have been mailed, emailed, or hand-delivered to all counsel of record this 28th day of May, 2019.

/s/ Lera Shemwell