BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Petition of	)	
Missouri-American Water Company for	)	File No. WO-2019-0184
Approval to Change an Infrastructure	)	
System Replacement Surcharge (ISRS).	)	

MAWC'S BRIEF

COMES NOW Missouri-American Water Company ("MAWC" or "Company"), and, as its *Brief*, states as follows to the Missouri Public Service Commission ("Commission"):

TABLE OF CONTENTS

INTRODUCTION 2
PRIVATE LETTER RULING 3
ISRS STATUTE 4
WHAT IS THE ADIT ASSET (NET OPERATING LOSS) 6
NORMALIZATION ACCOUNTING AND CONSENT AGREEMENT 7
CONSEQUENCE OF VIOLATION 9
MAWC'S PROPOSED DTA/NOL 11
VIOLATION 13
STAFF/OPC ARGUMENTS 15
PLR IMPACT 19
CONCLUSION 21

INTRODUCTION

MAWC's current Infrastructure System Replacement Surcharge ("ISRS") was established in Commission Case No. WO-2018-0373. The application/petition to change that ISRS was filed by MAWC on February 20, 2019, and concerns eligible infrastructure system replacements made between October 1, 2018 and March 31, 2019.

While this case concerns the same issue as that in Case No. WO-2018-0373 – whether MAWC's accumulated deferred income tax ("ADIT") balance resulting from the Deferred Tax Liability ("DTL") should be reduced by the Deferred Tax Asset ("DTA") resulting from MAWC's net operating loss ("NOL") calculation – MAWC asks the Commission to take a fresh look at the issue based upon the record in this case. This is important because of the significant issue that is present.

Should the Internal Revenue Service ("IRS") ultimately find there to be a normalization violation as a result of the Commission's decision, tax professionals indicate that the consequence of such a violation would be the loss of accelerated depreciation for the Company on a going-forward basis. Those professionals further indicate that the only way to avoid the loss of accelerated depreciation where a normalization violation exists is to have an opportunity to cure such violation – not on a prospective basis, but from the beginning of the violation. The worst result for everyone involved (to include both the Company and its customers) would be an IRS finding of a normalization violation at a point in time when the opportunity to cure has passed. MAWC would very much like to avoid that situation.

The Commission must remember that the point of the ADIT calculation is to properly assign responsibility for the source of capital. Thus, to the extent customers provide "cost-free

capital" through the use of the tax effect of accelerated depreciation, the ADIT is used to reduce utility's rate base so that the company does not receive a return on that "cost-free capital."

The evidence in this case shows that MAWC will have a NOL associated with the eligible infrastructure system replacements made between October 1, 2018 and March 31, 2019. That is, when new revenues are compared to book tax depreciation difference and other items, the Company is experiencing a NOL for both 2018 and 2019 of a little more than $34 million. MAWC's calculations are within the meaning of Section 393.1000(1)(a) and the normalization rules, as the NOL reflected by MAWC is calculated expressly and exclusively based upon such eligible plant and the actual ISRS revenues.

On the other hand, Staff's calculation does not accurately reflect the cost-free capital associated with the ISRS plant as it steps outside the bounds of the statute and "borrows" from MAWC's base rate revenues to assert that customers have provided the necessary capital. In order for customers to have paid $9,290,765 of ADIT, Staff must impute, or "borrow," revenues from base rates set in the Company's last rate case.[1] However, those rates were set on a test year ending December 31, 2017, which did not include any of the ISRS plant investments made in 2018 and 2019.[2] Essentially, Staff is double counting thos base rate revenues in order to reduce the ISTS revenue requirement.

PRIVATE LETTER RULING

Soon after the Commission ruled in Case No. WO-2018-0373, MAWC began the process of pursuing a Private Letter Ruling from the Internal Revenue Service ("IRS"), while trying to

[1] Tr. 81-83, Oligschlaeger.
[2] *Id*.

keep avenues open for the Commission to be able to remediate any concerns validated by the IRS in the ruling process.[3]

The steps it has taken, which were somewhat slowed by the United States government shut down in December/January, have included creation of the draft Private Letter Ruling request, formal notice to the IRS of a potential normalization violation, and a pre-submission conference with the IRS.[4]

MAWC is now in the final stages of the Private Letter Ruling process. That final stage is the process of working with Staff to agree on the final content that should be included in the PLR request.[5]

Thereafter, MAWC will file its Private Letter Ruling request with the IRS, along with a $30,000 application fee. It is anticipated that it will take up to 6 months for the IRS to issue its decision after the request has been filed.[6]

ISRS STATUTE

As is always the case with an ISRS case issue, one must start with a review of the statutory language in question. In this case the relevant language is found in Section 393.1000(1)(a), RSMo, which 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 accumulated depreciation *associated with eligible infrastructure system replacements* which are included in a currently effective ISRS.

[3] Exh. 1, Wilde Dir., p. 9-10.
[4] Exh. 1, Wilde Dir., p. 10-11.
[5] Exh. 1, Wilde Dir., p. 10.
[6] Exh. 1, Wilde Dir., p. 11.

(emphasis added).

The statute specifically calls for "recognition of accumulated deferred income taxes." Staff witnesses Oligschlaeger and Lyons, as well as MAWC witness Wilde, agreed that "accumulated deferred income taxes" include both Deferred Tax Assets and Deferred Tax Liabilities.[7] The Deferred Tax Asset at issue in this case is the Net Operating Loss ("NOL").

Staff generally agrees that "rate base reduction for [accumulated deferred income taxes ("ADIT")] must be offset by amounts related to incurred NOLs, to reflect that the companies were not able to currently use all of the tax deductions available to them and for which deferred taxes were booked" and that "failure to recognize the NOL offset for ratemaking purposes would constitute a violation of the normalization provisions of the IRS Code, by effectively passing accelerated depreciation deduction benefits on to customers prematurely."[8] In fact, Staff witness Lyons stated that it is reasonable to assume that the balance of MAWC's ADIT Asset (NOL) booked prior to 2018 is currently included in MAWC's base rates as an offset to the ADIT liability in the Company's last general rate case, Case No. WR-2017-0285.[9]

The ISRS is a form of single-issue ratemaking that is only concerned with identifying the incremental or isolated revenue requirement related to ISRS eligible plant investments.[10] Staff witness Oligschlaeger agreed that the ISRS statute is only concerned with identifying the incremental or isolated revenue requirement related to ISRS eligible plant investments put into service during the period of time at issue.[11]

---

[7] Tr. 118-119, Lyons; Tr. 76, 79, Oligschlaeger; Exh. 1, Wilde Dir., p. 4.
[8] Exh. 8, Olisgschlaeger Dir., p. 6.
[9] Exh. 6, Lyons Dir., p. 5; *See also* Tr. 77, Oligschlaeger.
[10] Tr. 78, Oligschlaeger.
[11] Tr. 78, Oligschlaeger.

Because the ISRS is viewed as an exception to the general rule against single-issue ratemaking, the ISRS statutes are viewed by the courts very narrowly.[12] Accordingly, only the items outlined in the statute should be examined – and they should be examined in isolation.[13] However, as will be described later, Staff's approach to accumulated deferred income taxes violates this approach by reaching outside the ISRS "test period" to calculate a DTL that customers have not paid in their current ISRS rate and ignore a DTA (i.e. the NOL experienced during the ISRS period).

WHAT IS THE ADIT ASSET (NET OPERATING LOSS)

It may be helpful to describe the ADIT Asset (Net Operating Loss ("NOL")) that is being discussed in this case. As starting place, one must understand that Congress enacted accelerated depreciation (e.g., bonus depreciation, repairs, etc.) to stimulate investment in the economy.[14] It is this special treatment of depreciation that both drives the creation of ADIT and forms the basis of the normalization rules at issue.

In ratemaking, the main component of ADIT arises from differences in how a utility's assets are depreciated for ratemaking purposes (straight-line) versus how they are depreciated for federal income tax purposes (accelerated). For example, tax law sometimes allows a company to claim accelerated depreciation in calculating its taxes, which is greater than the straight-line depreciation used in setting rates. The same amount of taxes eventually must be paid using either accelerated or straight-line depreciation, as long as the tax rate is unchanged. However,

---

[12] *See PSC v. Office of Pub. Counsel (In re Laclede Gas Co.)*, 539 S.W.3d 835 (Mo. Ct. App. 2017) and *Verified Application & in re Liberty Energy (Midstates) Corp. v. Office of Pub. Counsel*, 464 S.W.3d 520 (Mo. 2015).
[13] Tr. 120, Lyons; Tr. 78-79, Oligschlaeger.
[14] IRS Revenue Proc. 2-17-47 ("Congress enacted the ITC and accelerated depreciation to stimulate investment."

the early period tax reductions provide companies that use accelerated depreciation with what amounts to an interest-free loan equal to the amount of their deferred taxes. To keep utility customers from paying a rate of return on an interest-free loan, the utility's rate base is reduced by an amount equal to the utility's ADIT.[15]

However, when bonus depreciation and other tax deductions push the company's taxable income into the negative, the available tax deduction cannot offset any tax liability <u>and no "free" cash (or interest-free loan) is generated</u>. In that circumstance, the company must record an offsetting DTA for Net Operating Loss. The NOL offsets the ADIT liabilities and, therefore, the NOL has the effect of increasing the rate base.[16]

Again, this emphasis on the impact of the ADIT asset on the availability of cost-free capital is significant when discussing the impact of the normalization rules as the intent of those rules is to insure such cost-free capital.

NORMALIZATION ACCOUNTING AND CONSENT AGREEMENT

The intent of Congress in creating the normalization rules is to provide the utility an interest free source of funds to invest in utility property.[17] To the extent that the utility does not receive this interest free source of funds (or cost-free capital) because taking the accelerated depreciation deduction causes a taxable loss, that taxable loss needs to be included in the numbers so that the customers are not benefiting before the utility company receives the

[15] *See In the Matter of Union Electric Company d/b/a Ameren Missouri's Tariff*, 2015 Mo. PSC LEXIS 380, *22-23, 320 P.U.R.4th 330, ER-2014-0258 (April 29, 2015).
[16] *Id*.
[17] IRS Revenue Proc. 2-17-47 ("Congress enacted the ITC and accelerated depreciation to stimulate investment."

benefits.[18] The normalization rules say that the accelerated depreciation used in the Cost of Service calculation (for current expense) must use the same method and life used in the rate base reduction so as not to have a mismatch of the benefits.[19]

Staff witness Oligschlaeger provided the following background describing the normalization method of accounting:

> For rate purposes, the tax benefits associated with timing differences can either be assigned to ratepayers upfront by reducing the amount of income tax expense the utility would otherwise recover from its customers (i.e., the "flow-through" method of ratemaking for income taxes), or those benefits can be retained by the utility for a period of time before being passed on to ratepayers (the "normalization" method of ratemaking for income taxes).
>
> ***********
> For utility ratemaking, the concept of tax normalization is applied by collecting income tax expense amounts in rates calculated as if the particular tax deduction or treatment was not available to the utility.[20]

In most situations, while a state utility regulatory commission is aware of tax impacts, it would not be required to treat taxes in any particular manner from a ratemaking standpoint. The "normalization rules" contain one of the few direct interactions between the IRS and decisions by state utility regulatory commissions.

> . . . [I]n regard to the specific timing differences associated with use of accelerated depreciation methods for tax purposes, the IRS Code effectively mandates that regulatory commissions normalize the benefits of the accelerated depreciation tax deductions in setting rates. If the regulatory commissions do not allow for such normalization treatment, that action could result in loss of the entire accelerated depreciation deduction by the utility.[21]

---

[18] Exh. 1, Wilde Dir., p. 5.
[19] *Id*.
[20] Exh. 8, Olisgschlaeger Dir., p. 3; Exh. 1, Wilde Dir., p. 6.
[21] Exh. 8, Olisgschlaeger Dir., p. 4; Exh. 1, Wilde Dir., p. 6.

"In essence, the tax normalization requirements of the IRS Code mandate that utility rates be set so that customers do not receive the tax benefit of accelerated depreciation deductions any faster than over the estimated straight-line book lives authorized for the utilities' assets."[22]

In addition to being subject to the existing normalization rules applicable to depreciation, "[i]n 2010, the Company entered into a consent agreement with the IRS which authorized the Company's requested Change in Accounting Method to allow the utilization of the repairs deduction/method."[23] If the Company did not agree to the terms, then it would not have been allowed the additional repairs deductions on its tax returns.[24] One of the requirements of that consent agreement is that MAWC use a normalized method of accounting, even though a tax repairs deduction is not otherwise specifically subject to that the tax normalization rules.[25]

The Commission has typically, if not in every instance, followed the tax normalization requirements in the past.[26] In fact, Staff witness Oligschlaeger affirmatively stated that it is better for customers that the tax normalization rules be followed.[27]

CONSEQUENCE OF VIOLATION

The consequences for violation of the normalization rules are extremely significant. A finding by the Internal Revenue Service during an audit (or as the result of a required self-report by MAWC) that the Company violated the tax normalization rules, or the terms of the IRS consent agreement, could cause the loss of significant tax benefits currently benefiting

---

[22] Exh. 8, Olisgschlaeger Dir., p. 4.
[23] Exh. 1, Wilde Dir, p. 18.
[24] *Id*.
[25] *Id*. at p. 18-19.
[26] Tr. 71, Oligschlaeger.
[27] Tr. 72, Oligschlaeger.

customers. Specifically, MAWC could lose its ability to claim accelerated tax depreciation deductions and tax repair deductions.[28]

More specifically, in the case of a violation, the consequences depend on the Company's ability to work with the Commission to cure the violation. If the Company has the ability to collect the revenue from customers that should have been collected in those periods where the violation occurred, then there should be no adverse consequences. If the Company is unable to cure the violation, in other words, has no mechanism to appeal the decision and be made whole for these revenues, for example either through a Commission rehearing or as a result of an appellate proceeding, then the Company could lose the ability to use accelerated depreciation in the future.[29]

In the absence of an available cure, MAWC witness Wilde is only aware of situations where a Federal legislative exception was made.[30] Mr. Wilde provided as examples two utilities that but for an act of Congress would have permanently lost their use of accelerated depreciation.[31]

If the Company were no longer able to use accelerated depreciation or take the repairs deduction, it would result in higher rates for customers. Both the repairs deduction and accelerated depreciation allow the Company to expense investments faster for tax purposes than for book purposes. This differential, previously described as a "zero interest loan" from the government, is a reduction to rate base. All else being equal, both the Company's revenue

---

[28] Exh. 1, Wilde Dir., p. 9.
[29] Exh. 1, Wilde Dir., p. 12.
[30] Exh. 1, Wilde Dir., p. 12.
[31] Exh. 1, Wilde Dir., p. 13.

requirement and the customer's rates are lower when the Company can utilize this tax treatment.[32]

For this reason, both counsel for the Staff and the OPC stated that should Staff's approach create a normalization violation, they would agree that the amounts identified by MAWC should be added to the ISRS revenue requirement.[33]

MAWC'S PROPOSED DTA/NOL

OPC witness Riley acknowledged that MAWC expended money to construct the ISRS plant that is the subject of this case.[34] Therefore, the ADIT balance included in rate base should be representative of the cost-free funds that became available to MAWC as a result of MAWC's incremental ISRS investments placed in service between October 1, 2018 and March 31, 2019. This ADIT balance should include the incremental change in all deferred tax balances, which include both Deferred Tax Liabilities ("DTL") and Deferred Tax Assets ("DTA"). The incremental change in DTL relates to additional accelerated tax depreciation and tax repair deductions, and the incremental change in DTA relates to incremental Net Operating Loss ("NOL") deductions, which are associated with the ISRS investments.

The calculation of the DTL and the DTA/Net Operating Loss ("NOL") MAWC proposes to reflect are contained in the Direct Testimony of MAWC witness Brian LaGrand.[35] The Company included depreciation and interest expense that occurred during the ISRS period, as

---

[32] Exh. 1, Wilde Dir., p. 14
[33] Tr. 26-27, Staff Counsel; Tr. 27-28, OPC Counsel.
[34] Tr. 59, Riley.
[35] Exh. 4, LaGrand Dir., Sched. BWL-2.

well as accelerated depreciation, and the repairs deduction.[36] These deductions, taken against little ISRS revenue, create a NOL that is specifically associated with the ISRS investments. (*Id.*) This NOL is multiplied by the effective tax rate to determine the DTA to include in rate base. (*Id.*)

MAWC included total ADIT of ($544,893) in this case, which was a decrease to rate base, and represents the amount of zero-cost capital made available to MAWC on an incremental basis.[37] The DTA/NOL included by MAWC equaled $8,764,653.[38] The ISRS revenue requirement increase required if the DTA/NOL is included in this case is $827,383.[39]

Staff's understanding of the calculation also seems to be in error. Staff witness Lyons testified as follows:

> MAWC sums the tax timing differences related to repairs and accelerated depreciation with depreciation expense and interest expense, and then subtracts those reductions from ***zero***. Zero represents the revenue that MAWC has yet to recover in regard to this ISRS investment.[40]

(emphasis added)

During cross examination, Ms. Lyons admitted that MAWC's NOL calculation did not assume "zero" revenue, but instead included approximately $4.25 million in revenue associated with the prior ISRS.[41] However, when that revenue is compared to book tax depreciation difference and other items, the Company is experiencing a net operating loss for both 2018 and

[36] Exh. 4, LaGrand Dir., Sched. BWL-2, p. 2 of 7;
[37] Exh. 4, LaGrand Dir., Sched. BWL-2, p. 1 of 7, total of lines 7, 25, and 32. Lines 7 and 25 combine to represent the $526,112 in Net Deferred Income Taxes found on page 2 of 7, line 75 ($253,833, plus $272,279). The remainder is the accumulated depreciation from the prior ISRS ($18,781).
[38] *Id.* at Sched. BWL-2, p. 2 of 7, total of ALL Property for 2018 and 2019 on line 73; Exh. 7, Lyons Reb., Sched. KL-r1.
[39] Exh. 7, Lyons Reb., Sched. KL-r1.
[40] Exh. 6, Lyons Dir., p. 4.
[41] Tr. 124, Lyons.

2019 of a little more than $34 million.[42] That is the number used by Mr. LaGrand on Line 71of Schedule BWL-2 (after application of a 25.4% tax factor) to derive the $8.7 million DTA.[43]

Staff witness Lyons further confirmed that the depreciation expense, interest expense, and pretax income used by the Company are all associated with the qualified ISRS plant.[44] There are no expenses associated with non-ISRS plant in the calculation.[45]

VIOLATION

As part of a normalized method of accounting, and consistent with the tax normalization rules, the cumulative balance of plant-related deferred taxes is treated as a "zero interest loan" from the government and is a reduction to rate base. Including the DTL related to claiming deductions on ISRS-eligible investment, without including the DTA that results from those deductions, would cause the reduction to rate base to be greater than the "zero interest loan" actually received from the government. Thus, the surcharge would reflect the incremental ISRS-eligible investments being financed with an interest free loan, when in fact those incremental expenditures are being financed with debt and equity. This result is not consistent with the economic result the Commission and Missouri General Assembly intended by allowing for an ISRS mechanism. This result is also inconsistent with the applicable tax normalization rules, and inconsistent with the tax repairs IRS Consent Agreement described below, which the Company is subject to and which requires a normalized method of accounting be used for tax repairs.[46]

[42] Tr. 125, Lyons.
[43] Tr. 125, Lyons.
[44] Tr. 125, Lyons.
[45] Tr. 126, Lyons.
[46] Exh. 1, Wilde Dir., p. 11-12.

The Company has not received any cost-free funds to finance the new ISRS investments[47] and will finance those capital costs with debt and equity. In addition, it is the Company that funded $66,167,640 of ISRS eligible expenditures during the ISRS period and those eligible expenditures drove the $34,441,075 of tax deductions and the $8,764,652 DTL, However, claiming those additional deductions for the ISRS period when MAWC's taxable income and tax liability was $0 required an offsetting DTA related to previously claimed NOL deductions.[48]

A plain reading of Section 393.1006(1)(a), RSMo, indicates that MAWC should recover the weighted cost of capital associated with ISRS plant. The rate base in that calculation includes ADIT. Both Staff witness Lyons and Oligschlaeger agree the ADIT should be the net accumulated deferred tax balance associated with ISRS and that this amount should be representative of interest free capital available to fund these investments. However, ultimately, Staff does just the opposite. Staff calculates an ADIT balance related to ISRS eligible property by assuming additional interest free capital of $9,290,765 was made available to fund $66,167,640 of expenditures.[49] Staff acknowledges that customers have not paid ADIT of $9,290,765, as MAWC has only collected $4,251,973 of ISRS revenue in 2018 and 2019 to date.[50] In order for customers to have paid $9,290,765 of ADIT, Staff must impute, or "borrow," revenues from base rates set in the Company's last rate case.[51] However, those rates were set on

---

[47] Tr. 80, Oligschlaeger.
[48] Exh. 2, Wilde Reb., p. 9.
[49] Tr. 128, Lyons.
[50] Tr. 124, Lyons.
[51] Tr. 81-83, Oligschlaeger.

a test year ending December 31, 2017, which did not include any of the ISRS plant investments made in 2018 and 2019.[52]

Staff witness Lyons identifies MAWC's customers as the source of the additional capital, and the deferred tax expense collected from customers as the method by which it was supplied. OPC witness Riley states that "the utility expended no monies . . .," but fails to identify the source of funding if not the utility. Neither Staff witness Lyons nor OPC witness Riley explain how the $9,290,765 of additional capital was provided while current taxes are assumed to be zero (based on the existence of a NOLC at of the end of 2017, 2018, and 2019.[53]

Excluding the DTA from the incremental Net Operating Loss results in Total ADIT of ($9,290,765), implies an additional $8,764,652 of interest-free capital became available to MAWC during the ISRS period.[54] However, since MAWC is not currently a federal cash taxpayer, this interest-free capital has not been made available to MAWC.

STAFF/OPC ARGUMENTS

The Staff has argued that the Deferred Tax Asset reflected by MAWC is "hypothetical" and not appropriate for recovery in an ISRS rate calculation.[55] OPC witness Riley similarly argues that "an NOL is a tax return adjustment not a regulatory item" and, thus, "an accounting fiction."[56] These arguments are without basis as the calculation of the Deferred Tax Asset (or NOL) is no more "hypothetical" than the Deferred Tax Liability (the impact of accelerated depreciation) that Staff and OPC reflect in the ISRS calculation. OPC witness Riley agreed that

---

[52] *Id*.
[53] Exh. 2, Wilde Reb., p. 9-10.
[54] The difference in these numbers ($526,112) is the total of lines 7 and 25 of Exh. 4, LaGrand Dir., Sched. BWL-2, p. 1 of 7, and is also described as the Net Deferred Income Taxes on page 2 of 7, line 75 ($253,833, plus $272,279).
[55] Exh. 6, Lyons Dir., p. 4.
[56] Exh. 12, Riley Dir., p. 2.

accelerated depreciation is a tax return adjustment and no accelerated depreciation has yet been claimed on a tax return for the ISRS plant that is the subject of this case.[57] Because of this, Staff witness Lyons has no idea what accumulated deferred income taxes MAWC will have on its 2018 tax return.[58] However, Staff and OPC have included those amounts in their calculation of the DTL.

Staff's allegation is also based, in part, on its assertion that "MAWC is not generating or booking any actual NOL during the ISRS period."[59] However, this assertion is not supported by the data Staff cites. In support, Staff witness Lyons reproduces a MAWC data request response showing the MAWC Deferred Income Tax Asset balance over the period of December 2017 through December 2019.[60] MAWC witness Wilde updated this chart through April 2019, in his Rebuttal Testimony.[61] One can see that the Deferred Income Tax Asset (NOL) balance actually increases between May 2018 and June 2018; September 2018 and October 2018; October 2018 and November 2018; and, January 2019 and February 2019.[62] The balance is not always decreasing as alleged by Staff. Moreover, the presence of an NOLC at the end of the year means that MAWC is not currently paying tax, and as of the respective period means that, MAWC has no capacity to reduce its tax liability and achieve the tax cash flow that Staff and OPC suggest.[63]

This analysis also does not take into account that but for those eligible ISRS Investments the use of the NOLC during that period would have been less. This is because there is a limitation on that amount of tax deductions you can claim for tax repairs or tax depreciation to

[57] Tr. 60, Riley.
[58] Tr. 117, Lyons.
[59] Exh. 6, Lyons Dir., p. 5.
[60] Exh. 6, Lyons Dir., p. 6.
[61] Exh. 2, Wilde Reb., p. 6.
[62] *Id.*
[63] *Id.*

the extent you are not cash taxpayer at the end of the day and carrying forward a loss, you will not benefit all of those deductions.[64] The incremental ISRS-eligible investments would generate tax deductions in excess of income generated, so on an incremental basis investing in ISRS plant will generate an additional tax loss.[65]

In fact, Staff witness Oligschlaeger admitted his awareness of the Company's data request response indicating that net operating loss carryforward would have been $7 million lower, if the 2018 ISRS investments had not occurred.[66] He further agreed that under a hypothetical scenario where MAWC did make any ISRS plant additions, then they would have been able to use more NOL to offset ongoing taxable income.[67] This leads him to the conclusion that "all other things being equal, presumably [MAWC's] taxable income would be higher and they could have used more of the prior generated NOL to offset that amount."[68]

Staff further argues that the NOL is not appropriate for recovery in an ISRS rate calculation because "[i]f MAWC's methodology is used, the existence of a hypothetical net operating loss will always result from the calculation, whether the utility is actually recording an NOL amount on its books or not."[69] This is not the situation before the Commission, however. The fact pattern here is that there is a NOLC deduction waiting to be claimed at the end of each period, eliminating any opportunity to raise additional interest-free capital on an incremental basis by claiming ISRS related deductions.[70]

---

[64] Exh. 2, Wilde Dir., p. 5.
[65] Exh. 1, Wilde Dir., p. 15.
[66] Tr. 88, Oligschlaeger.
[67] *Id*.
[68] Tr. 103, 105, Oligschlaeger.
[69] Exh. 6, Lyons Dir., p. 4.
[70] Exh. 2, Wilde Reb., p. 7.

The NOL at issue in this case is calculated by the Company based on book and tax deductions associated with eligible ISRS plant. Thus, there is necessarily an NOL resulting from the ISRS plant in this case.

On the other hand, the DTL calculated by Staff is not connected to the eligible ISRS plant. Staff made no attempt to address that part of the NOL related to accelerated depreciation on non-ISRS plant as opposed to that portion associated with ISRS plant.[71]

During the ISRS period no new revenue was generated by the new ISRS plant and no new revenue will be generated associated with the ISRS plant additions until the new ISRS rate becomes effective.[72] Even then, the Company will not collect its full annual ISRS revenue requirement until the rate has been in effect for 12 months.[73] Staff witness Oligschlaeger confirmed that for its calculations, Staff must assume that revenues from MAWC's base rates – revenues that are NOT *associated with 2018 and 2019 eligible infrastructure system replacements* – are funding the DTL.[74]

23 Q. So if I understand your response, customers are
24 not paying income tax expense related to the current ISRS plant
25 or ISRS period through an ISRS surcharge currently in effect.
1 Right?
2 A. Well, they have not been directly reflected in
3 an ISRS surcharge.
4 Q. Okay. But you believe they are getting it
5 somehow through their base rates that were established in a
6 general rate case. Right?
7 A. Well, they are getting a recovery of costs and
8 again hopefully some return through ongoing payments by
9 customers in rates. While the return on equity may fluctuate
10 over time based on new costs that a company incurs, it is still
11 assumed for fundamental accounting and ratemaking purposes that

[71] Tr. 90, Oligschlaeger.
[72] Tr. 80-81, Oligschlaeger.
[73] Tr. 86, Oligschlaeger.
[74] Tr. 81, 82, 84, 85, Oligschlaeger.

12 the Company is recovering all of the costs on its books.
13· Q. But none of the ISRS plant that is the subject of
14 this case was in the Company's rate base at the time its last
15 base rates were set. Right?
16 A. That is correct.
*****
2 Q. No tax expense is being recovered from customers
3 currently?
4 A. For new ISRS plant additions?
5 Q. Yes?
6 A. Okay. Again, if you define recovery in rates as
7 meaning an item is explicitly included in rates through a
8 commission order through an ISRS or base rates, then your
9 assumption would follow through. Again, for purposes of
10 accounting for their financial results and for setting rates
11 that is not how recovery is measured.[75]

Staff witness Lyons agreed that when the ISRS is viewed in "isolation," it is clear the customers through ISRS rates in this case and the prior case have not paid enough revenue to support the deferred tax liability reflected by Staff.[76] Thus, Staff assumes that the deferred tax liability has been paid by customers from base rates.[77] This violates the Section 393.1000(1)(a) requirement that accumulated deferred income taxes be "associated with eligible infrastructure system replacements."

PLR IMPACT

In a private letter ruling, PLR 201548017, the IRS representative states as follows in relevant part:

> Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the

[75] Tr. 81-83, Oligschlaeger.
[76] Tr. 129, Lyons.
[77] Tr. 128, Lyons.

> amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). [78]

(emphasis added)

The above makes it clear that at least the amount of the NOL Carryforward attributable to accelerated depreciation should be included as an increase to rate base to offset the decrease from accelerated depreciation.[79] Similarly, in this case, the rate base is being reduced for deferred taxes as a result of the ADIT Liability. Accordingly, the amount of the NOL attributable to the eligible ISRS plant should be included as an increase to rate base to offset the decrease from accelerated depreciation.

Staff seems to argue that the normalization rules do not apply here because of the nature of this proceeding as a single-issue rate mechanism. However, Staff is not aware of any PLR that supports such an interpretation and believes this is a case of first impression for the IRS.[80] However, it is doubtful that such authority exists or will ever exist. That is because of the before-mentioned purpose of the normalization rules – to provide the utility an interest free source of funds to invest in utility property. Any proceeding, general rate case or otherwise, where the Deferred Tax Liability is recognized, without similar recognition of the Deferred Tax

[78] Exh. 1, Wilde Dir., Sched. JRW-1.
[79] Exh. 1, Wilde Dir., p. 21.
[80] Tr. 99, 100, Oligschlaeger.

Asset, eliminates that interest free source of funds to invest in utility property and results in a normalization violation.[81]

CONCLUSION

Staff and OPC's proposal to eliminate the recognition of the Deferred Tax Asset (NOL) is inconsistent with a normalized method of accounting because the impact of ignoring the Deferred Tax Asset provides customers with the benefit of the tax deduction now, via a lower ISRS rate, even though the Company is unable to benefit from those tax deductions at this time and is, therefore, also inconsistent with the ISRS statute.

WHEREFORE, MAWC respectfully submits this *Brief* for the Commission's consideration.

Respectfully submitted,

____
William R. England III, MBE #23975
Dean L. Cooper, MBE #36592
BRYDON, SWEARENGEN &
ENGLAND P.C.
312 E. Capitol Avenue
P. O. Box 456
Jefferson City, MO 65102
(573) 635-7166
dcooper@brydonlaw.com

Timothy W. Luft, MBE #40506
Corporate Counsel
MISSOURI-AMERICAN WATER
COMPANY
727 Craig Road
St. Louis, MO 63141
(314) 996-2279 telephone
(314) 997-2451 facsimile
timothy.luft@amwater.com

ATTORNEYS FOR MISSOURI-AMERICAN WATER COMPANY

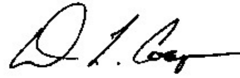
[81] Exh. 1, Wilde Dir., p. 22.

CERTIFICATE OF SERVICE

l hereby certify that a copy of the above and foregoing document was sent via electronic mail on this 24th day of May, 2019, to:

Mark Johnson
Casi Aslin
Office of the General Counsel
staffcounselservice@psc.mo.gov
casi.aslin@psc.mo.gov
mark.johnson@psc.mo.gov

Lera Shemwell
Office of the Public Counsel
opcservice@ded.mo.gov
lera.shemwell.ded.mo.gov



____