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Income Taxes
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Case Nos.: WR-2015-0301/SR-2015-0302

**DIRECT TESTIMONY
OF
RALPH C. SMITH**

Submitted on Behalf of
the Office of the Public Counsel

MISSOURI AMERICAN WATER COMPANY

Case Nos. WR-2015-0301/SR-2015-0302

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**Denotes Highly Confidential Information
that has been redacted**

December 23, 2015

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1 **CONFIDENTIAL DIRECT TESTIMONY**
2 **OF**
3 **RALPH C. SMITH**

4 **MISSOURI AMERICAN WATER COMPANY**

5 **CASE NOS. WR-2015-0301/SR-2015-0302**

6 **I. INTRODUCTION**

7 **Q. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.**

8 A. Ralph C. Smith. I am a Senior Regulatory Consultant at Larkin & Associates, PLLC,
9 15728 Farmington Road, Livonia, Michigan 48154.

10 **Q. PLEASE DESCRIBE LARKIN & ASSOCIATES.**

11 A. Larkin & Associates, PLLC is a Certified Public Accounting and Regulatory Consulting
12 firm. The firm performs independent regulatory consulting primarily for public
13 service/utility commission staffs and consumer interest groups (public counsels, public
14 advocates, consumer counsels, attorneys general, etc.). Larkin & Associates has
15 extensive experience in the utility regulatory field as expert witnesses in over 600
16 regulatory proceedings including numerous telephone, water and sewer, gas, and electric
17 matters.

18 **Q. MR. SMITH, PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.**

1 A. I received a Bachelor of Science degree in Business Administration (Accounting Major)
2 with distinction from the University of Michigan - Dearborn, in April 1979. I passed all
3 parts of the Certified Public Accountant (“C.P.A.”) examination in my first sitting in
4 1979, received my CPA license in 1981, and received a certified financial planning
5 certificate in 1983. I also have a Master of Science in Taxation from Walsh College,
6 1981, and a law degree (J.D.) cum laude from Wayne State University, 1986. In
7 addition, I have attended a variety of continuing education courses in conjunction with
8 maintaining my accountancy license. I am a licensed C.P.A. and attorney in the State of
9 Michigan. I am also a Certified Financial Planner™ professional and a Certified Rate of
10 Return Analyst (“CRRA”). Since 1981, I have been a member of the Michigan
11 Association of Certified Public Accountants. I am also a member of the Michigan Bar
12 Association and the Society of Utility and Regulatory Financial Analysts (“SURFA”). I
13 have also been a member of the American Bar Association (“ABA”), and the ABA
14 sections on Public Utility Law and Taxation.

15 **Q. PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.**

16 A. Subsequent to graduation from the University of Michigan, and after a short period of
17 installing a computerized accounting system for a Southfield, Michigan realty
18 management firm, I accepted a position as an auditor with the predecessor CPA firm to
19 Larkin & Associates in July 1979. Before becoming involved in utility regulation where
20 the majority of my time for the past 36 years has been spent, I performed audit,
21 accounting, and tax work for a wide variety of businesses that were clients of the firm.

1 During my service in the regulatory section of our firm, I have been involved in rate
2 cases and other regulatory matters concerning electric, gas, telephone, water, and sewer
3 utility companies. My present work consists primarily of analyzing rate case and
4 regulatory filings of public utility companies before various regulatory commissions, and,
5 where appropriate, preparing testimony and schedules relating to the issues for
6 presentation before these regulatory agencies.

7 I have performed work in the field of utility regulation on behalf of industry, state
8 attorneys general, consumer groups, municipalities, and public service commission staffs
9 concerning regulatory matters before regulatory agencies in Alabama, Alaska, Arizona,
10 Arkansas, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Indiana, Illinois,
11 Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi,
12 Missouri, New Jersey, New Mexico, New York, Nevada, North Carolina, North Dakota,
13 Ohio, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont,
14 Virginia, Washington, Washington D.C., West Virginia, and Canada, as well as the
15 Federal Energy Regulatory Commission and various state and federal courts of law.

16 **Q. HAVE YOU PARTICIPATED OR TESTIFIED PREVIOUSLY BEFORE THE**
17 **COMMISSION?**

18 A. Yes, I have testified before the Missouri Public Service Commission (PSC or
19 Commission) regarding Missouri Gas Energy, Case No. GR-96-285. I have submitted
20 testimony involving Empire District Electric Company, Case No. ER-2006-0315 and

1 Kansas City Power & Light Company, Case No. ER-2006-0314. I also participated in
2 proceedings involving Southwestern Bell Telephone Company, Case No. TR-81-208;
3 Arkansas Power & Light Company, Case No. ER-83-206; and United Telephone
4 Company of Missouri, Case No. TR-85-179.

5 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE OTHER STATE PUBLIC**
6 **UTILITY REGULATORY COMMISSIONS?**

7 A. Yes, I have testified before other state public utility regulatory commissions on many
8 occasions.

9 **Q. HAVE YOU SUBMITTED TESTIMONY IN REGULATORY PROCEEDINGS**
10 **INVOLVING RATE CASES OF OTHER AMERICAN WATER WORKS**
11 **UTILITIES?**

12 A. Yes. I have submitted testimony in proceedings involving Kentucky American Water
13 Company in Case Nos. 8836 and 2010-00036; Pennsylvania American Water Company
14 in Docket Nos. R-00922428, R-00932670, R-2010-2166208, R-2010-2166210, R-2010-
15 2166212, R-2010-2166214, R-2011-2232243, R-2013-2355276; Virginia American
16 Water Company in Case No. PUE-2008-00009; Illinois American Water Company in
17 Docket Nos. 09-0319 and 11-0767; Arizona American Water Company in Docket Nos.
18 W-01303A-09-0343 and SW-01303A-09-0343; West Virginia American Water
19 Company in Case Nos. 10-0920-W-42T, 12-1649-W-42T, and 15-0676-W-42T;

1 California American Water Company in Application 10-07-007; and Indiana American
2 Water Company in Cause No. 44022.

3 **Q. HAVE YOU PREPARED AN ATTACHMENT SUMMARIZING YOUR**
4 **EDUCATIONAL BACKGROUND AND REGULATORY EXPERIENCE?**

5 A. Yes. Schedule RCS-1 provides details concerning my experience and qualifications.

6 **Q. HAVE YOU PREPARED ANY EXHIBITS TO ACCOMPANY YOUR**
7 **TESTIMONY?**

8 A. Yes. Schedule RCS-2 presents certain pages from American Water Works 2010 Form
9 10-K. Schedule RCS-3 presents a page from American Water Works 2014 Form 10-K.
10 Schedule RCS-4 reflects my recommended adjustment to depreciation expense as it
11 relates to MAWC's Business Transformation program. Schedule RCS-5 presents an
12 excerpt from a California Public Utilities Commission Decision involving California-
13 American Water Company. Schedule RCS-6 presents an excerpt from an Indiana Utility
14 Regulatory Commission Order involving Indiana-American Water Company. Schedule
15 RCS-7 reflects my recommended Domestic Production Activities Deduction (Section
16 199) deduction to MAWC's federal income taxes. Schedule RCS-8 presents selected
17 non-confidential material that is referenced in my testimony and schedules. Schedule
18 RCS-9 presents selected confidential material that is referenced in my testimony and
19 schedules.

1 **Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY ON REVENUE**
2 **REQUIREMENT ISSUES?**

3 A. The purpose of my testimony is to present Public Counsel's recommendations with
4 regard to specific revenue requirement issues in this proceeding, including the Company's
5 Business Transformation program and certain issues related to income taxes, including
6 calculating an adjustment to income tax expense on a separate return basis for the
7 Domestic Production Activities Deduction. I also address the parent company, American
8 Water Works decision to not claim bonus tax depreciation in a number of years when it
9 was available, due to considerations at the parent company consolidated level about net
10 operating loss carryforwards and charitable contribution carryforwards.

11 **II. REVENUE REQUIREMENT ISSUES**

12 **A. *Business Transformation***

13 **Q. WHAT IS THE AMERICAN WATER WORKS BUSINESS TRANSFORMATION**
14 **INITIATIVE?**

15 A. This is an American Water Works initiative to develop new business systems and to
16 deploy the related information technology projects on a system-wide basis. As discussed
17 in the Direct Testimony of Company witness VerDouw, the Business Transformation
18 ("BT") program is the development and system-wide deployment of new, integrated
19 information technology systems as well as the process of implementing these systems

1 such that they properly align business processes with the increased capabilities of the new
2 systems. Mr. VerDouw identified four specific areas of focus for the BT program
3 including: (1) replacing legacy systems that are at or near the end of their useful lives; (2)
4 promoting operating excellence, efficiency and economies of scale; (3) enhancing the
5 customer experience; and (4) increasing employee effectiveness and satisfaction. In
6 addition, Mr. VerDouw stated that the scope of the BT program includes a range of core
7 functional areas, which include: human resources, finance and accounting, purchasing
8 and inventory management, capital planning, cash management as well as customer and
9 field services.

10 **Q. WAS THE BT PROGRAM ADDRESSED IN THE COMPANY'S LAST RATE**
11 **CASE?**

12 A. Yes. In Case No. WR-2011-0337, a Non-Unanimous Stipulation and Agreement
13 ("Stipulation") was reached among the parties on February 24, 2012 and was approved by
14 the Commission in its Order dated March 7, 2012.¹ The BT program was discussed at
15 Paragraph 19 of the Stipulation under the heading "Special Accounting for Business
16 Transformation System."

17 **Q. PLEASE DISCUSS THE SPECIAL ACCOUNTING FOR THE BT PROGRAM**
18 **PER THE TERMS OF THE STIPULATION FROM CASE NO. WR-2011-0337.**

¹ Page 3 of the Commission's Order states that since no parties objected to the Stipulation within seven days of the filing of the agreement, the Commission treated the agreement as if it were unanimous.

1 A. Pursuant to the Stipulation, a new subaccount designated Account 391.4 - BTS Initial
2 Investment was added to Staff's recommended depreciation schedules in that prior
3 proceeding. A depreciation rate of 5% was assigned to the hardware and software capital
4 investments that related to the BT program. That 5% depreciation rate was to be used to
5 accrue depreciation on the BT costs that MAWC was instructed to record in Subaccount
6 391.4 - BTS Initial Investment. The Stipulation provides that the 5% depreciation rate is
7 to be used until the Commission authorizes a different depreciation and amortization
8 treatment for the BT program assets.

9 **Q. WHAT SERVICE LIFE WAS ASSIGNED TO THE BT PROGRAM ASSETS IN**
10 **THE STIPULATION?**

11 A. According to Appendix B which was a schedule of depreciation rates that was filed in
12 conjunction with the Stipulation, for water and sewer operations, the BT program assets
13 in Account 391.4 - BTS Initial Investment was given an average service life of 20 years
14 with zero net salvage. The depreciation rates and service life of the BT assets are
15 discussed in further detail below. The 20-year life and zero net salvage were
16 implemented at a 5% annual depreciation rate to be applied to the BT capital investments
17 that were to be recorded in a new subaccount.

18 **Q. WHAT OTHER ACCOUNTING TREATMENT WITH REGARD TO THE BT**
19 **PROGRAM WAS DISCUSSED IN THE STIPULATION?**

1 A. With regard to the accounting treatment for the BT program assets prior to their in-
2 service date, which was in accordance with a Stipulation and Agreement that was filed in
3 MAWC Case No. WR-2010-0131, the Stipulation stated in part:

4 Costs associated with the CPS and Business Transformation Project [BTS]
5 shall be accounted for on the books of the Company as construction work
6 in progress (CWIP)...The Company shall transfer the CWIP balances to
7 Utility Plant in Service when in-service in accordance with the NARUC
8 Uniform System of Accounts and, beginning in the month immediately
9 following transfer, shall record depreciation thereon at the appropriate
10 Commission approved depreciation rate.

11
12 **Q. WHAT ARE THE MAJOR COMPONENTS OF THE AMERICAN WATER**
13 **WORKS BUSINESS TRANSFORMATION INITIATIVE?**

14 A. As discussed on pages 12 and 13 of Mr. VerDouw's Direct Testimony, the three major
15 components of the American Water Works Business Transformation initiative are:

- 16 • Enterprise Resource Planning (“ERP”), which encompasses applications that will
17 support human resources, finance and accounting, and supply chain/procurement
18 management.
- 19 • Enterprise Asset Management (“EAM”), which will support the management of asset
20 lifecycles including the design, construction, commissioning, operations,
21 maintenance, decommissioning, and replacement of plant, equipment and facilities as
22 well as work management for customer service field work (service turn-ons, leak
23 inspections, etc.) and transmission and distribution system work.
- 24 • Customer Information System (“CIS”), which contains all billing and personal data
25 pertaining to the Company's customers including billing rates, water consumption,
26 associated charges, meter information, and the strategy for managing and nurturing
27 the Company's interactions with its customers.

1 **Q. THE STIPULATION IN CASE NO. WR-2011-0337 STATES THAT THE**
2 **COMPANY SHALL TRANSFER THE CWIP BALANCES TO UTILITY PLANT**
3 **IN SERVICE WHEN IN-SERVICE IN ACCORDANCE WITH THE NARUC**
4 **UNIFORM SYSTEM OF ACCOUNTS AND, BEGINNING IN THE MONTH**
5 **IMMEDIATELY FOLLOWING TRANSFER, SHALL RECORD**
6 **DEPRECIATION THEREON AT THE APPROPRIATE COMMISSION**
7 **APPROVED DEPRECIATION RATE. ARE THE BT PROGRAM ASSETS**
8 **CURRENTLY IN SERVICE?**

9 A. Yes. The Direct Testimony of MAWC witness VerDouw at page 19, states that the new
10 systems were deployed in two phases between 2012 and 2013. Specifically, Mr.
11 VerDouw stated that the ERP system went live in August 2012 and the CIS and EAM
12 systems went live in May 2013.

13 **Q. WHAT AMOUNTS FOR THE AMERICAN WATER WORKS BUSINESS**
14 **TRANSFORMATION HAS MAWC PROPOSED TO INCLUDE IN RATE BASE?**

15 A. As discussed on page 15 of his Direct Testimony, Mr. VerDouw stated the overall
16 American Water Works BT program costs were estimated to be \$326.2 million through
17 December 2014. Of this amount, the amount allocated to MAWC of \$46.5 million, or
18 approximately 14.24% of the total costs as of December 31, 2014, is based on a
19 percentage of MAWC's customer counts to the overall customer counts of American

1 Water. The Company proposes to include the \$46.5 million for BT in MAWC's rate
2 base.

3 **Q. MR. VERDOUW REFERRED TO THE OVERALL BT PROGRAM COSTS OF**
4 **\$326.2 MILLION AND THE \$46.5 MILLION ALLOCATED TO MAWC AS**
5 **ESTIMATES. ARE THE ACTUAL OVERALL BT PROGRAM COSTS AND**
6 **THOSE ALLOCATED TO MAWC KNOWN AT THIS TIME?**

7 A. Yes. In its response to OPC 5003, the Company stated that the reference to the amounts
8 being estimates in Mr. VerDouw's testimony is due to the amounts listed on Schedule
9 GMV-1,² which listed actual amounts as of December 31, 2014, being rounded to the
10 nearest \$100,000. Schedule GMV-1 indicates that from 2009 through December 31,
11 2014, total American Water Works BT program costs totaled \$326,240,408 and that the
12 amount allocated to MAWC for the same period totaled \$46,469,957.

13 **Q. WHAT ELSE DOES SCHEDULE GMV-1 SHOW?**

14 A. In addition to showing the total overall American Water Works BT program costs
15 through December 31, 2014 and the amount of that total that AWWC allocated to
16 MAWC, Schedule GMV-1 also reflects the amount of the overall BT program's costs to
17 AWWC's other regulated utilities and to American Water Works Service Company

² Schedule GMV-1 was filed in conjunction with Mr. VerDouw's Direct Testimony.

1 ("AWWSC" or "Service Company"). None of AWWC's non-regulated subsidiaries³ are
2 reflected on Schedule GMV-1.

3 **Q. WHAT IS AWWC'S BASIS FOR ALLOCATING THE \$326.2 MILLION OF THE**
4 **BT PROGRAM COSTS ALMOST ENTIRELY TO THE AMERICAN WATER**
5 **WORKS REGULATED UTILITIES?**

6 A. MAWC has attempted to justify the allocation from AWWC to MAWC on the basis of its
7 affiliated Service Company agreement with AWWSC.

8 **Q. WHAT CONCERNS ARE RAISED BY THIS?**

9 A. The AWWSC agreement is decades old and has not been updated with changes in the
10 American Water Works system. Allocating the cost of this \$326.2 million BT project
11 almost exclusively to its regulated utilities and only on the basis of a customer count of
12 American Water Works' regulated utility operations has not been adequately justified.

13 Additionally, the AWWSC charges to MAWC are supposed to be "at cost" and do not
14 include a return element. However, by attempting to include such affiliated company
15 charges to MAWC for financing costs related to the affiliate Laurel Oak Properties
16 "lease" of portions of the American Water Works BT project,⁴ MAWC has been charged
17 for BT financing costs in those affiliated charges.

³ These are referred to as "market based subsidiaries."

⁴ See page 20 (lines 21-23) of the Direct Testimony of Company witness Gary M. VerDouw.

1 **Q. HAS AMERICAN WATER WORKS PUT ITS SHAREHOLDERS ON NOTICE**
2 **ABOUT RISKS RELATED TO ITS BT INITIATIVES?**

3 A. Yes. As one example, American Water Works' 2010 Securities and Exchange
4 Commission ("SEC") Form 10-K for the period 2010 filed with the SEC on February 28,
5 2011, at page 27,⁵ contained the following warning/disclosure to shareholders about the
6 American Water Works BT initiatives:

7 Our business transformation initiative ("BT") involves risks, could result
8 in higher than expected costs or otherwise adversely impact our operations
9 and profitability.

10 We have undertaken a business transformation project, which is intended
11 to upgrade our antiquated and manual processes and systems. This multi-
12 year, enterprise-wide initiative is intended to support our broader strategic
13 initiatives. The project is intended to optimize workflow throughout our
14 field operations, improve our back-office operations and enhance our
15 customer service capabilities. **The scale and anticipated future costs**
16 **associated with the business transformation project are significant**
17 **and we could incur significant costs in excess of what we are planning**
18 **to spend. Any technical or other difficulties in developing or**
19 **implementing this initiative may result in delays, which, in turn, may**
20 **increase the costs of the project. When we make adjustments to our**
21 **operations, we may incur incremental expenses prior to realizing the**
22 **benefits of a more efficient workforce and operating structure.**
23 **Further, we may not realize the cost improvements and greater**
24 **efficiencies we hope for as a result of the project. In addition, we can**
25 **provide no guarantee that we will be able to achieve timely or**
26 **adequate rate recovery of these increased costs associated with the**
27 **transformation project.**

28 Currently, we operate numerous systems that have varying degrees of
29 integration, which can lead to inefficiencies, workarounds and rework. As
30 such, delays in the initiative being put into service will also delay cost
31 savings and efficiencies expected to result from the project. We may also
32 experience difficulties consolidating our current systems, moving to a

⁵ A copy of the referenced SEC 10-K page is provided in Schedule RCS-2.

1 common set of operational processes and implementing a successful
2 change management process. These difficulties may impact our customers
3 and our ability to meet their needs efficiently. Any such delays or
4 difficulties may have a material and adverse impact on our business, client
5 relationships and financial results.

6 (Emphasis added.)

7 As noted in the above SEC 10-K report, American Water Works put shareholders on
8 notice that the BT project was risky and that AWW “could incur significant costs in
9 excess of what [AWW] ... [was] planning to spend.” American Water Works also put
10 shareholders on notice that: “... we may incur incremental expenses prior to realizing the
11 benefits of a more efficient work force and operating structure.” As noted above,
12 however, American Water Works and MAWC have attempted to capitalize additional
13 expense as BT “plant in service” costs, rather than expensing the additional expense
14 incurred for BT during the periods in which such expenses were incurred.

15 Finally, American Water Works clearly advised shareholders that: “... we can provide no
16 guarantee that we will be able to achieve timely or adequate rate recovery of these
17 increased costs associated with the transformation project.” Thus, shareholders have
18 received clear warnings from American Water Works in this and other SEC filings about
19 the risk associated with increased costs associated with the American Water Works BT
20 project and therefore, should not be surprised if regulators hold shareholders responsible
21 for some of the cost increases and those cost increases for BT in excess of what American
22 Water Works told shareholders it was planning to spend.

23

1 Q. WHAT HAS AMERICAN WATER WORKS DISCLOSED TO INVESTORS
2 ABOUT THE LEVEL OF EXPENDITURES RELATED TO ITS BT
3 INITIATIVES AND THE TIMING OF WHEN KEY SYSTEMS WERE
4 EXPECTED TO BE IN SERVICE?

5 A. Page 59 of the American Water Works' 2010 SEC Form 10-K had made the following
6 disclosures about spending amounts and the timing of when the BT systems were
7 anticipated to be in service.⁶

8 During the remainder of 2011, we will begin the detailed design and build
9 of the Enterprise Resource Planning ("ERP") application. We expect to
10 have all three enterprise-wide systems or applications—the ERP, a new
11 customer information system and an enterprise asset management
12 system—implemented by the end of 2014.

13 **Current estimates indicate that BT expenditures could total as much**
14 **as \$280 million.** Through December 31, 2010, we have spent \$34.5
15 million on the project. Expenditures associated with BT are included in the
16 estimated capital investment spending of \$800 million to \$1 billion capital
17 investment spending outlined above. **As with any other initiative of this**
18 **magnitude, there are risks that could result in increased costs. Any**
19 **technical difficulties in developing or implementing this initiative,**
20 **such as implementing a successful change management process, may**
21 **result in delays, which in turn, may increase the costs of the project**
22 **and also delay and, perhaps, reduce any cost savings and efficiencies**
23 **expected to result from the initiative. When we make adjustments to**
24 **our operations, we may incur incremental expenses prior to realizing**
25 **the benefits of a more efficient workforce and operating structure.**
26 **While we believe such expenditures can be recovered through**
27 **regulated rates, we can provide no guarantee that we will be able to**
28 **achieve timely rate recovery of these increased costs associated with**
29 **this transformation project. Any such delays or difficulties**
30 **encountered with such recovery may have a material and adverse**
31 **impact on our business, customer relationships and financial results.**

⁶ See Schedule RCS-2 for a copy of the cited page.

1 We believe that **the goals of BT—increasing our operating efficiency**
2 **and effectiveness and controlling the costs associated with the**
3 **operation of our business—are important to providing the quality**
4 **service to our customers and communities we serve.**

5 (Emphasis added.)

6 Page 26 of the American Water Works’ 2014 SEC Form 10-K dated February 24, 2015,
7 made the following updated disclosures about spending amounts and the timing of when
8 Business Transformation systems such as the ERP were placed into service:⁷

9 *Our inability to efficiently optimize and stabilize our recently*
10 *implemented business transformation project, could result in higher*
11 *than expected costs or otherwise adversely impact our internal controls*
12 *environment, operations and profitability.*

13 Over the past several years, we have implemented a “business
14 transformation” project, which is intended to improve our business
15 processes and upgrade our legacy core information technology systems.
16 This multi-year, enterprise-wide initiative supports our broader strategic
17 initiatives. The project is intended to optimize workflow throughout our
18 field operations, improve our back-office operations and enhance our
19 customer service capabilities. **The scale and costs associated with the**
20 **business transformation project were significant. Any technical or**
21 **other difficulties in optimizing and stabilizing this initiative may**
22 **increase the costs of the project and have an adverse effect on our**
23 **operations** and reporting processes, including our internal control over
24 financial reporting. In August 2012, our new business systems associated
25 with Phase I of our business transformation project became operational.
26 Phase I consisted of the roll-out of the ERP, which encompassed
27 applications that handle human resources, finance, and supply
28 chain/procurement management activities. In the second quarter of 2013,
29 Phase II of our business transformation project was implemented in our
30 remaining regulated subsidiaries. Phase II consisted of the roll-out of a
31 new Enterprise Asset Management system, which manages an asset’s
32 lifecycle, and a Customer Information system, which will contain all
33 billing and data pertaining to American Water’s customers for our
34 Regulated segment. **Although efforts have been made to minimize any**

⁷ See Schedule RCS-3 for a copy of the cited page.

1 **adverse impact on our controls, we cannot assure that all such**
2 **impacts have been mitigated.**

3 **As we make adjustments to our operations, we may incur incremental**
4 **expenses prior to realizing the benefits of a more efficient workforce**
5 **and operating structure. Further, we may not realize anticipated cost**
6 **improvements and greater efficiencies from the project.**

7 We operate numerous information technology systems that are in various
8 stages of integration, sometimes leading to inefficiencies. Therefore,
9 delays in stabilization and optimization of the business transformation
10 project will also delay cost savings and efficiencies expected to result
11 from the project. **We may also experience difficulties consolidating our**
12 **current systems, moving to a common set of operational processes and**
13 **implementing a successful change management process. These**
14 **difficulties may impact our ability to meet customer needs efficiently.**
15 **Any such delays or difficulties may have a material and adverse**
16 **impact on our business, client relationships and financial results.**

17 (Emphasis added.)
18

19 **Q. HAVE THE COSTS FOR THE AMERICAN WATER WORKS BT INCREASED**
20 **SIGNIFICANTLY?**

21 **A.** It appears they have. The SEC disclosures noted above stated that "BT expenditures
22 could total as much as \$280 million." In the current rate case, MAWC witness VerDouw
23 at page 15 of his Direct Testimony stated that the total cost of the BT program was
24 \$326.2 million as of December 31, 2014. Mr. VerDouw offered no explanation for the
25 approximately \$46.2 million cost overrun (\$326.2 million - \$280.0 million) or any
26 explanation as to why Missouri ratepayers should pay for the proposed 14.24 percent
27 allocation to MAWC of the American Water Works BT system cost overruns. Until and
28 unless MAWC can provide explanations of the BT cost overruns and why ratepayers
29 should absorb them (rather than shareholders, who were advised of the BT risks in the

1 American Water Works' SEC filings, such as those quoted above), ratepayers should be
2 protected from being charged with an allocation of such inadequately explained
3 American Water Works BT cost overruns.

4 **Q. AFTER MENTIONING THE \$326.2 MILLION TOTAL PROJECT COST FOR**
5 **THE BT PROGRAM AND THE MAWC \$46.5 MILLION TOTAL PROJECT**
6 **COST ALLOCATION ON PAGE 15 OF HIS DIRECT TESTIMONY, WHAT**
7 **DOES MR. VERDOUW STATE ABOUT THE COMPONENTS OF THE TOTAL**
8 **BT COST?**

9 A. At page 20 of his Direct Testimony, Mr. VerDouw stated that there are four areas of total
10 cost for the BT project: (1) physical assets (primarily servers, networking equipment,
11 etc.); (2) software licenses; (3) capitalized labor costs; and (4) initial planning studies.

12 **Q. WHAT DOES AMERICAN WATER WORKS CONSIDER TO BE THE CORE**
13 **ENTERPRISE SOFTWARE AS IT RELATES TO THE BT PROGRAM?**

14 A. As explained by Mr. VerDouw at page 16 of his Direct Testimony, in early 2010,
15 American Water Works selected SAP as its core enterprise software solution platform.

16 **Q. ARE THERE ANY BT SYSTEMS THAT DO NOT USE THE SAP SOFTWARE**
17 **PLATFORM?**

18 A. No. The response to OPC 5015 states that the SAP platform is a fully integrated system.

1 **Q. WHEN A CORE ENTERPRISE SOFTWARE PLATFORM IS IMPLEMENTED,**
2 **SHOULD THE COST OF THE NEW CORE SOFTWARE PLATFORM BE**
3 **SHARED AMONG THE GROUP OF AMERICAN WATER WORKS**
4 **ENTERPRISES, WHICH INCLUDE BOTH THE REGULATED UTILITIES AND**
5 **A GROUP OF NON-REGULATED OR MARKET-BASED BUSINESSES?**

6 A. Yes, the cost of a core American Water Works enterprise software platform, such as
7 SAP, should be shared enterprise-wide.

8 **Q. HOW ARE THE BT PROGRAM COSTS ALLOCATED IN THE COMPANY'S**
9 **FILING?**

10 A. As shown on Schedule GMV-1, AWWC allocated the full \$326.2 million cost to
11 American Water Works' regulated utilities, including MAWC, and to the Service
12 Company.

13 **Q. DO ANY OF AWWC'S NON-REGULATED OPERATIONS OR SUBSIDIARIES**
14 **HAVE LICENSES FOR ANY OF THE SOFTWARE INCLUDED IN THE BT**
15 **SYSTEM?**

16 A. Yes. In response to OPC 5012, the Company stated the following:

17 American Water Works Service Company, Inc. is licensed to use all of the
18 BT related software applications. The BT systems are designed for
19 American Water's regulated utilities, and American Water Company's
20 "non-regulated" or market-based affiliates. American Water Enterprises
21 ("AWE") owns and operates separate finance, accounting, management of

1 asset lifecycle, customer service, customer billing and strategic planning
2 systems, which satisfy the market-based operational needs.
3

4 **Q. HAS MAWC PROPOSED TO ALLOCATE ANY SAP OR BT COSTS TO THE**
5 **PARENT COMPANY, AWWC, IN ITS FILING?**

6 A. No. The parent company, American Water Works, also uses the BT SAP systems, yet
7 MAWC proposes to allocate no BT costs to AWWC. Allocation of BT costs to the
8 entities that are using the SAP systems is appropriate.

9 **Q. YOU PREVIOUSLY STATED THAT PURSUANT TO APPENDIX B OF THE**
10 **STIPULATION THAT WAS APPROVED IN CASE NO. WR-2011-0337, THE BT**
11 **PROGRAM ASSETS IN ACCOUNT NO. 391.4 - BTS INITIAL INVESTMENT**
12 **WERE ASSIGNED A DEPRECIATION RATE OF 5% WITH AN AVERAGE**
13 **SERVICE LIFE OF 20 YEARS. DOES THE COMPANY'S FILING IN THE**
14 **CURRENT PROCEEDING REFLECT THE 5% DEPRECIATION RATE AND**
15 **20-YEAR AVERAGE SERVICE LIFE?**

16 A. It reflects that rate for historical depreciation expense accruals, but not prospectively. For
17 prospective ratemaking, MAWC proposes a depreciation rate of 10% which is twice as
18 high as the currently approved depreciation rate. At page 20 of his Direct Testimony, Mr.
19 VerDouw stated that: "BT is a capital investment. At a cost to Missouri-American of
20 approximately \$46.5 million, the program is intended to provide benefits to the Company
21 and its customers for the ten year projected life of the investment." In addition, Mr.

1 VerDouw states on page 22 of his testimony that the appropriate annual depreciation rate
2 for the BT assets is 10 percent as indicated in the depreciation study performed by
3 Company witness Spanos.

4 **Q. THE STIPULATION IN CASE NO. WR-2011-0337 STATED THAT THE BT**
5 **PROGRAM SOFTWARE AND HARDWARE CAPITAL INVESTMENTS**
6 **WOULD BE REFLECTED IN ACCOUNT 391.4 BTS - INITIAL INVESTMENT.**
7 **ARE THE BT PROGRAM ASSETS STILL REFLECTED IN THIS ACCOUNT?**

8 A. No. The attachment provided with OPC 5007 reflects the following breakout of the BT
9 program components by account:

		BT Program
		Assets
		As of
BT Program Components	Account	12/31/2014
Comprehensive Planning Study (CPS)		
Other P/E - CPS	339600	\$ 63,759
Computer Software Mainframe	340310	\$ 60,912
Total CPS		\$ 124,671
Enterprise Resource Planning (ERP)		
Computer & Peripheral Equipment	340200	\$ 429
Computer Software Mainframe	340310	\$ 17,664,339
Total ERP		\$ 17,664,768
Enterprise Asset Management (EAM)		
Computer Software Mainframe	340310	\$ 10,133,319
Total EAM		\$ 10,133,319
Customer Information Systems (CIS)		
Computer Software Mainframe	340310	\$ 14,703,928
Total CIS		\$ 14,703,928
Controls/Organizational Integration		
Computer Software Mainframe	340310	\$ 3,843,116
Total Controls/Organizational Integration		\$ 3,843,116
Business Transformation Grand Total		\$ 46,469,802
Source: OPC 5007		

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As shown in the above table, the components of the BT program include the three aforementioned core projects of the BT program listed above (i.e., the ERP, EAM, and CIS). In addition, the attachment provided with OPC 5007 also listed two additional areas of BT costs, including (1) Comprehensive Planning Study ("CPS"), and (2) Controls/Organizational Integration.

Q. WHAT CURRENT DEPRECIATION RATES HAS MAWC APPLIED TO THE PLANT ACCOUNTS LISTED IN THE TABLE ABOVE?

1 A. The Company's response to OPC 5007 lists the following current depreciation rates for
2 these plant accounts:

- 3 • Account 339600 - Other P/E - CPS: 0%
- 4 • Account 340200 - Computer and Peripheral Equipment: 20%
- 5 • Account 340300 - Computer Software: 20%
- 6 • Account 340310 - Computer Software Mainframe: 5%
- 7 • Account 340330 - Computer Software Other: 20%

8
9 The 5% depreciation rate for Account 340310 - Computer Software Mainframe, in which
10 \$46,405,614, or 99.86% of the \$46,469,802 million of BT program related costs were
11 recorded, reflects the depreciation rate based on a 20-year life that was assigned to the BT
12 related software and hardware capital investments pursuant to the Stipulation in Case
13 No. WR-2011-0337.

14 **Q. WHAT LEVEL OF BT PROGRAM RELATED DEPRECIATION EXPENSE DID**
15 **MAWC RECORD DURING THE TEST YEAR?**

16 A. According to the attachment provided with the response to OPC 5007, as of the end of
17 the test year, using the current depreciation rates noted above, MAWC recorded BT
18 program related depreciation expense totaling \$2,325,289 as summarized in the table
19 below:

		2014
		Depreciation
BT Program Component	Account	Expense
Comprehensive Planning Study (CPS)		
Other P/E - CPS	339600	\$ -
Computer Software Mainframe	340310	\$ 3,046
Total CPS		<u>\$ 3,046</u>
Enterprise Resource Planning (ERP)		
Computer & Peripheral Equipment	340200	\$ 86
Computer Software Mainframe	340310	\$ 867,897
Total ERP		<u>\$ 867,983</u>
Enterprise Asset Management (EAM)		
Computer Software Mainframe	340310	\$ 506,076
Total EAM		<u>\$ 506,076</u>
Customer Information Systems (CIS)		
Computer Software	340200	\$ 45,550
Computer Software Mainframe	340310	\$ 708,714
Computer Software - Other	340330	\$ 1,766
Total CIS		<u>\$ 756,030</u>
Controls/Organizational Integration		
Computer Software Mainframe	340310	\$ 192,154
Total Controls/Organizational Integration		<u>\$ 192,154</u>
Business Transformation Grand Total 2014 Depreciation Expense		<u><u>\$ 2,325,289</u></u>
Source: OPC 5007		

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Q. WHAT ARE THE COMPANY'S PROPOSED DEPRECIATION RATES FOR THE BT PROGRAM RELATED PLANT ACCOUNTS LISTED IN THE TABLE ABOVE?

1 A. The Company's response to OPC 5007 reflects the following depreciation rates which are
2 being proposed by the Company for these BT program related plant accounts: ⁸

- 3 • Account 339600 - Other P/E - CPS: 3.03%
- 4 • Account 340200 - Computer and Peripheral Equipment: 20%
- 5 • Account 340300 - Computer Software: 10%
- 6 • Account 340310 - Computer Software Mainframe: 10%
- 7 • Account 340330 - Computer Software Other: 10%
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9 **Q. WHAT LEVEL OF BT PROGRAM RELATED DEPRECIATION EXPENSE HAS**
10 **MAWC REFLECTED IN ITS FILING BASED ON ITS PROPOSED**
11 **DEPRECIATION RATES?**

12 A. According to the attachment provided with the response to OPC 5007, using the proposed
13 depreciation rates noted above, MAWC has reflected BT program related depreciation
14 expense totaling \$4,642,579 as summarized in the table below:

⁸ The proposed depreciation rates for the BT program related accounts are being sponsored by Company witness John Spanos.

		Depreciation Expense Under Proposed Depreciation Rates
BT Program Component	Account	
Comprehensive Planning Study (CPS)		
Other P/E - CPS	339600	\$ 1,932
Computer Software Mainframe	340310	\$ 6,091
Total CPS		\$ 8,023
Enterprise Resource Planning (ERP)		
Computer & Peripheral Equipment	340200	\$ 86
Computer Software Mainframe	340310	\$ 1,766,434
Total ERP		\$ 1,766,520
Enterprise Asset Management (EAM)		
Computer Software Mainframe	340310	\$ 1,013,332
Total EAM		\$ 1,013,332
Customer Information Systems (CIS)		
Computer Software	340200	\$ -
Computer Software Mainframe	340310	\$ 1,470,393
Computer Software - Other	340330	\$ -
Total CIS		\$ 1,470,393
Controls/Organizational Integration		
Computer Software Mainframe	340310	\$ 384,312
Total Controls/Organizational Integration		\$ 384,312
Business Transformation Grand Total		\$ 4,642,579
Source: OPC 5007		

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Q. HOW WERE THOSE AMOUNTS CALCULATED?

A. The Company calculated the proposed depreciation expense amounts by multiplying the BT program related plant balances as of December 31, 2014 by its proposed depreciation rates. It should be noted that in the attachment provided with OPC 5007, for the CIS

1 component, the Company did not calculate depreciation expense under proposed rates for
2 Account 340200 - Computer Software or Account 310330 - Computer Software Other.

3 **Q. DID MR. VERDOUW STATE WHAT THE BASIS IS FOR THE COMPANY'S**
4 **PROPOSED DEPRECIATION RATES FOR THE BT PROGRAM ASSETS?**

5 A. Not specifically. On page 22 of his Direct Testimony, Mr. VerDouw merely stated: "The
6 appropriate annual depreciation rate for the BT assets is ten percent as included in the
7 Depreciation Study performed by Company witness John Spanos and made a part of this
8 rate case filing." Beyond this statement, Mr. VerDouw did not address the basis for the
9 Company's proposed depreciation rates for the BT program assets.

10 **Q. PURSUANT TO MR. VERDOUW'S REFERENCE TO THE DEPRECIATION**
11 **STUDY, WHAT DID MR. SPANOS SAY WAS THE BASIS FOR THE**
12 **COMPANY'S PROPOSED DEPRECIATION RATES FOR THE BT PROGRAM**
13 **ASSETS?**

14 A. Mr. Spanos did not directly address the BT program assets in his Direct Testimony.
15 What Mr. Spanos did say on page 8 of his testimony is that the general plant accounts for
16 water assets, including Account 340.3 (where 99.86% of the BT program assets are
17 recorded) include a very large number of units, but represent less than four percent of
18 depreciable water plant. In addition, Mr. Spanos stated that depreciation accounting is
19 difficult for these general plant assets as periodic inventories are necessary to properly
20 reflect plant in service. On page V-5 of Schedule JJS-1 from the depreciation study, Mr.

1 Spanos listed his proposed amortization periods for the general plant accounts for water
2 assets. Included in this listing was Account 340.30 - Computer Software, to which Mr.
3 Spanos assigned a 10 year amortization period, which equates to a 10% depreciation rate.
4 Notably, neither MAWC nor Mr. Spanos have provided any evidence that the
5 approximately \$326.2 million spent by American Water Works on BT systems will have
6 produced systems that have no use or value after 10 years.

7 **Q. DO YOU AGREE WITH MR. SPANOS' PROPOSED DEPRECIATION RATES**
8 **AND AMORTIZATION PERIOD FOR THE PLANT ACCOUNTS WHICH**
9 **RELATE TO THE BT PROGRAM ASSETS?**

10 A. No. I am recommending that BT program assets be depreciated using the current
11 depreciation rates pursuant to the Stipulation from Case No. WR-2011-0337. As noted
12 above, the Stipulation stated that BT program assets would accrue depreciation at a 5%
13 depreciation rate (which equates to a 20-year amortization period) until the Commission
14 orders a different depreciation or amortization treatment for these assets.

15 **Q. WHY ARE YOU RECOMMENDING THAT THE BT PROGRAM ASSETS**
16 **CONTINUE TO BE DEPRECIATED OVER A 20-YEAR PERIOD USING**
17 **CURRENT DEPRECIATION RATES?**

18 A. I am recommending that the BT program assets be depreciated over 20 years at current
19 rates because in my opinion, the Company has not demonstrated why a departure from
20 depreciating the BT program assets over a 20-year period is warranted. MAWC has not

1 provided compelling reasons for why the \$326.2 million worth of assets and systems
2 associated with the BT projects should not be expected to last beyond the ten-year period
3 it is proposing in this case.

4 **Q. WHY SHOULD THE COST OF THE AMERICAN WATER WORKS BT**
5 **SYSTEM THAT IS ALLOCATED TO MAWC CONTINUE TO BE**
6 **DEPRECIATED BY MAWC OVER A 20-YEAR PERIOD?**

7 A. The \$326.2 million cost of the American Water Works BT systems represents a very
8 significant investment in the future of the enterprise. It is notable that from 2009 through
9 the test year ended December 31, 2014, the total overall cost of the American Water
10 Works BT program was \$326.2 million. In addition, the cost of the BT program has
11 continued to increase since that time. According to the response to MoPSC 0182, the
12 overall total cost of the BT program increased to \$327.8 million through June 30, 2015,
13 or an additional \$1.6 million in the six months from the \$326.2 million incurred through
14 the test year ended December 31, 2014. Of the \$327.8 million, the amount allocated to
15 MAWC through June 30, 2015 totaled \$46.74 million or approximately an additional
16 \$200,000 since December 31, 2014. As noted earlier, the American Water Works BT
17 systems have included unexplained cost overruns from the initial cost estimate of
18 approximately \$280 million. Since MAWC has not provided any evidence that suggests
19 that the BT systems will not be used nor have any value after ten years, the Company's
20 proposal to depreciate these assets over a 10-year period (half of what was originally
21 approved for MAWC in its last rate case) is without adequate justification. Therefore, I

1 am recommending that the Company's proposal to depreciate the BT program assets over
2 10 years be rejected and that BT costs allocated to MAWC continue to be depreciated
3 over the 20-year period approved in MAWC's last rate case.

4 **Q. PLEASE SUMMARIZE YOUR RECOMMENDED ADJUSTMENT TO BT**
5 **RELATED DEPRECIATION EXPENSE.**

6 A. I have applied the current depreciation rates to the BT program plant balances as of
7 December 31, 2014. As shown on Schedule RCS-4, my recommended adjustment
8 reduces MAWC's requested BT related depreciation expense by \$2,320,281.

9 **Q. IN HIS TESTIMONY, MR. VERDOUW STATED THE BT PROGRAM IS**
10 **INTENDED TO PROVIDE BENEFITS TO THE COMPANY AND ITS**
11 **CUSTOMERS FOR THE TEN YEAR PROJECTED LIFE OF THE**
12 **INVESTMENT. WHAT BENEFITS HAS THE COMPANY IDENTIFIED AS A**
13 **RESULT OF IMPLEMENTING THE BT PROGRAM?**

14 A. In its confidential response to MoPSC 0184, the Company stated that while AWWC does
15 not track all cost savings related to the BT program, it has identified estimated cost
16 savings as well as avoided higher costs in 2014 in the areas of finance, customer service
17 center and supply chain. Specifically, as it relates to the areas of finance and the
18 customer service center, the Company indicated that the implementation of BT has **

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Q. WHAT COST SAVINGS AND COST AVOIDANCE DID THE COMPANY IDENTIFY WITH RESPECT TO ITS SUPPLY CHAIN THAT IS ATTRIBUTABLE TO THE BT INITIATIVE?

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A. The table below summarizes the Company's estimated cost savings and cost avoidance related to the various components of its supply chain for capitalized as well as operating costs.

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Q. HAS MAWC IDENTIFIED ANY OTHER BENEFITS ASSOCIATED WITH THE IMPLEMENTATION OF THE BT PROGRAM?

A. Yes. The response to MoPSC 0184 stated that AWWC determined that the benefits from the BT program being implemented provided the Company the opportunity to review its organizational structure to make it more efficient and cost effective. The confidential attachment provided with MoPSC 0184 included a table which I have replicated below and which **

**

Q. HAS THE COMPANY DEMONSTRATED THAT ALL OF THE BT SYSTEMS WOULD BE RETIRED FROM SERVICE IN TEN YEARS?

1 A. No. The Company has not demonstrated that all of the BT systems will be retired from
2 service in 10 years. As discussed above, in my opinion, MAWC has not provided a
3 compelling argument or sufficient justification for its proposal to cut the currently used
4 20-year life for the BT program assets in half, or conversely, to double the current 5%
5 depreciation rate for the American Water Works BT costs that are being allocated to
6 MAWC. I recommend that the existing 5% depreciation rate and 20-year life continue to
7 apply for MAWC's BT assets.

8 ***B. The Deduction for Domestic Production Activities under §199 of the***
9 ***Internal Revenue Code and an Illustrative “Separate Return” Basis***
10 ***Calculation of the DPAD***
11

12 **Q. WHAT IS THE DOMESTIC PRODUCTION ACTIVITIES DEDUCTION?**

13 A. The Domestic Production Activities Deduction ("DPAD"), which is also referred to as
14 the Internal Revenue Code §199 deduction or ("§199 deduction"), is a tax break for
15 businesses that perform domestic manufacturing and certain other production activities.
16 It was established by the American Jobs Creation Act of 2004 in an effort to ease the tax
17 burden of domestic manufacturers and as a result make the investment in domestic
18 manufacturing facilities more advantageous. Water treatment is considered to be a
19 domestic production activity that qualifies for this special income tax deduction.

20 **Q. FOR RATEMAKING PURPOSES, SHOULD THE DPAD FOR MAWC BE**
21 **EVALUATED ON A SEPARATE RETURN BASIS?**

1 A. Yes. To the extent that MAWC has positive federal taxable income on a separate return
2 basis for ratemaking purposes, and is using a separate return basis for income taxes in the
3 rate case, a deduction under §199 of the Internal Revenue Code should be evaluated on a
4 separate return basis. Because MAWC has its own water supply and treats the water,
5 such activities are considered domestic production activities, and thus MAWC is eligible
6 for the DPAD deduction if it has positive taxable income and meets the other
7 requirements for claiming the deduction.

8 **Q. HOW DOES THE PARTICIPATION IN A CONSOLIDATED FEDERAL**
9 **INCOME TAX RETURN AFFECT THE DPAD?**

10 A. MAWC also participates in the AWWC consolidated federal income tax return with its
11 parent company and other affiliates. On a consolidated return basis, AWWC has had
12 federal income taxes losses in recent years through 2014, and on a consolidated return
13 basis, AWWC also has a large net operating loss (“NOL”) carry forward, such that
14 AWWC is not expected to pay federal income tax in the foreseeable future.⁹ Because
15 MAWC participates in the AWWC consolidated federal income tax return, the tax
16 position of AWWC prevents the consolidated entity from claiming the §199 deduction on
17 the consolidated federal income tax return.

⁹ The AWWC NOL situation is discussed in a subsequent section of my testimony, in conjunction with addressing AWWC’s decision to opt out of taking 2011 and 2013 bonus tax depreciation.

1 **Q. PLEASE EXPLAIN WHY THE DPAD FOR MAWC SHOULD BE EVALUATED**
2 **ON A SEPARATE RETURN BASIS.**

3 A. Because current federal income tax expense and other income tax items are being
4 determined on a “separate return” basis for MAWC for ratemaking purposes in the
5 current rate case, and MAWC is projected to have positive federal taxable income under
6 new rates, the impact of the §199 deduction on MAWC’s “separate return” basis current
7 federal income tax expense should be determined and reflected for ratemaking purposes.
8 As noted above, MAWC did not qualify for the §199 deduction in some of the prior years
9 because the Company had a taxable loss in some of those years. MAWC stated that it
10 expects to have positive federal taxable income prospectively at its proposed rates.
11 Specifically, MAWC’s response to OPC 5038 indicates that at proposed rates, MAWC
12 anticipates having approximately \$27 million¹⁰ of positive federal taxable income. For
13 its income tax calculation for ratemaking purposes, MAWC has assumed that it will have
14 federal taxable income and has reflected having a positive amount of federal taxable
15 income tax of approximately \$27 million at its proposed rates.¹¹

16 **Q. ON WHAT FORM IS THE §199 DEDUCTION CALCULATED?**

17 A. The §199 deduction for Domestic Production Activities is computed on IRS form 8903.

¹⁰ As shown on page 2 of Company filing schedule CAS-10, the amount of anticipated positive federal taxable income for water operations totals approximately \$24 million.

¹¹ See response to OPC 5038.

1 **Q. DID MAWC PREPARE THAT FORM IN CONJUNCTION WITH ITS**
2 **SEPARATE RETURN BASED CALCULATION OF FEDERAL INCOME TAX**
3 **EXPENSE IN THE CURRENT RATE CASE?**

4 A. It appears not. Based on responses to discovery received to date, it appears that MAWC
5 did not prepare a form 8903 calculation for the Domestic Production Activities Deduction
6 on a separate return basis for its current rate filing.

7 **Q. DID MAWC PROVIDE CALCULATIONS FOR A §199 DEDUCTION FOR THE**
8 **TEST YEAR?**

9 A. No. In response to discovery received to date, it appears that MAWC did not prepare
10 calculations of the §199 deduction for the test year or for prospective ratemaking.

11 **Q. HAVE YOU SEEN THE §199 DEDUCTION ISSUE ARISE IN THE CONTEXT**
12 **OF A RATE CASE INVOLVING AN AMERICAN WATER UTILITY**
13 **OPERATING AFFILIATE?**

14 A. Yes. The issue of the reduction to current income tax expense based on calculating the
15 §199 deduction on a “separate return” basis was one of the issues involving income tax
16 expense in a California-American Water Company (“Cal-Am”) rate case, A.10-07-007.
17 In that case, Cal-Am had reflected the §199 deduction on a “separate return” basis for
18 purposes of computing current federal income tax expense for ratemaking purposes in
19 conjunction with the use of a forecast 2012 test year. The California Public Utilities

1 Commission ("CPUC") Department of Ratepayer Advocates ("DRA") also computed a
2 §199 deduction on a "separate return" basis for purposes of computing current federal
3 income tax expense for ratemaking purposes in conjunction with the use of a forecast
4 2012 test year. Both the Cal-Am and the DRA calculations reflected that Cal-Am would
5 have positive federal taxable income for ratemaking purposes for the 2012 test year that
6 was being used in that case. In rebuttal, Cal-Am claimed that it had large NOLs and
7 would therefore not have net positive taxable income and would therefore not be eligible
8 to claim the §199 deduction on a separate return basis. The §199 deduction issue, as well
9 as various other issues surrounding income taxes were contested by the DRA and by
10 TURN.¹² The income tax issues in the Cal-Am general rate case, including the §199
11 deduction, were addressed in the CPUC's final decision,¹³ which stated that:

12 The issue here is which of Cal-Am's tax positions should be used to
13 determine whether the DPAD is applicable. In this case, because Cal-
14 Am's tax position for ratemaking purposes resulted in income tax, it is
15 reasonable to apply the DPAD to reduce the income tax obligation for
16 ratemaking purposes.

17 The CPUC's ordering paragraph 21 (at page 92 of CPUC Decision 12-06-016)
18 states that:

19 California-American Water Company's taxable income shall be reduced
20 by the Domestic Production Activities Deduction calculated using the
21 Division of Ratepayer Advocates' methodology.
22

¹² TURN stands for The Utility Reform Network.

¹³ Excerpts from the CPUC's Decision 12-06-016 (June 7, 2012) in A.10-07-007 on the DPAD are attached to my testimony in Schedule RCS-2.L

1 **Q. TO YOUR KNOWLEDGE, WAS A SEPARATE RETURN BASIS**
2 **CALCULATION OF THE DPAD ADDRESSED IN ANOTHER AMERICAN**
3 **WATER UTILITY RATE CASE?**

4 A. Yes. In an Indiana-American Water Company rate case, Cause No. 44022, before the
5 Indiana Utility Regulatory Commission ("IURC"), the separate-return basis calculation of
6 the DPAD was addressed as one alternative to making a consolidated federal income tax
7 return-based adjustment to Indiana-American's federal income tax expense. In
8 addressing the federal income tax issues in that case, the IURC rejected the §199
9 Deduction adjustment "because that adjustment assumes a stand-alone income tax
10 expense calculation." The IURC's Order stated further that: "Insofar as we continue to
11 employ the Muncie Remand Method [which is a form of consolidated federal income tax
12 savings adjustment], we do not utilize a stand-alone calculation. As a result, it is
13 inappropriate to impute the §199 Deduction on a stand-alone basis."

14 **Q. HOW DOES THAT INDIANA-AMERICAN WATER COMPANY SITUATION**
15 **COMPARE WITH MAWC?**

16 A. As described above, the Indiana-American Water Company situation utilized a form of
17 consolidated federal income tax savings adjustment in computing the ratemaking
18 allowance for federal income taxes, and did not use a stand-alone basis. In contrast, for
19 ratemaking purposes, MAWC is using a stand-alone basis for income tax expense.
20 Where a stand-alone basis for federal income tax expense is being used for ratemaking

1 purposes as it is with MAWC (and as it has been with MAWC's affiliate Cal-Am), it is
2 appropriate to calculate the §199 Deduction on a stand-alone basis.

3 **Q. HAVE YOU ENCOUNTERED §199 DEDUCTION ISSUES, INVOLVING THE**
4 **INTERPLAY BETWEEN A “SEPARATE RETURN” BASED CALCULATION**
5 **AND THE IMPACT OF PARTICIPATING IN A CONSOLIDATED FEDERAL**
6 **INCOME TAX RETURN IN ANOTHER UTILITY RATE CASE?**

7 A. Yes. A similar issue arose in a rate case involving Georgia Power Company.¹⁴ On its
8 books, Georgia Power reflected a portion of the §199 deduction amount that is allocated
9 to Georgia Power as result of the Southern Company consolidated tax return.¹⁵ The
10 amount of the allocated deduction was lower than if it had been computed on a separate
11 stand alone tax return basis. Georgia Power’s computation of income tax expense for
12 book purposes was essentially based on the assumption that it files a separate standalone
13 tax return for all income and deductions, with the exception of the §199 Deduction, for
14 which it assumed that it files a consolidated tax return. In Georgia Power’s rate case, the
15 parties had reached an agreement in a stipulation that all components of the income tax
16 expense should be computed on a stand-alone separate tax return basis, including the
17 §199 Deduction as a matter of conceptual and computational consistency. It would not

¹⁴ See, e.g., Georgia Public Service Commission (“GPSC”), Docket No. 31958 and the preceding Georgia Power Company rate case.

¹⁵ \$7.222 million of this was reflected on Georgia Power’s projected “per books” amount and represents the reduced amount that reflects Georgia Power’s participation in a consolidated federal income tax return with Southern Company affiliates.

1 be appropriate to randomly quantify certain components of an income tax expense
2 computation on a stand-alone basis and other components on a consolidated basis.

3 **Q. HOW DOES THE USE OF A SEPARATE RETURN BASED CALCULATION OF**
4 **FEDERAL INCOME TAX EXPENSE APPLY IN THE CURRENT MAWC RATE**
5 **CASE?**

6 A. This principle of a separate return basis for computing federal income tax expense would
7 also apply to MAWC in its current rate case. MAWC has computed its federal income
8 tax expense for ratemaking purposes on a stand-alone or “separate return” basis. But
9 MAWC has not reflected the §199 deduction that it would be eligible for on a separate
10 return basis, using the taxable income that is it using to derive its claim for current federal
11 income tax expense at proposed rates.

12 **Q. HAVE YOU PREPARED A SCHEDULE WHICH SHOWS HOW A §199**
13 **DEDUCTION COULD BE CALCULATED FOR MAWC?**

14 A. Yes. Schedule RCS-7 shows a calculation of the §199 deduction and the related
15 reduction to income tax expense on a separate return basis for MAWC.

16 **Q. HOW SHOULD THE “SEPARATE RETURN” BASIS §199 DEDUCTION FOR**
17 **MAWC BE CONSIDERED IN THE CURRENT MAWC RATE CASE?**

18 A. It should be considered to the extent that the current federal income tax expense for
19 MAWC for ratemaking purposes is being determined on a “separate return” basis. The

1 components of the calculation of current federal income tax expense in the Company's
2 filing are on a "separate return" basis using information reflecting adjustments to
3 operating income and expenses that are being proposed for ratemaking purposes.
4 Consequently, the "separate return" basis §199 deduction should be used, and MAWC's
5 current federal taxable income at proposed rates should be reduced by \$329,486 at
6 MAWC's proposed rates as shown on Schedule RCS-7. The reduction to current federal
7 income tax expense shown on Schedule RCS-7 is \$115,320 at MAWC proposed rates.
8 The §199 deduction shown on Schedule RCS-7 should be reflected for ratemaking
9 purposes. It should be noted that the §199 deduction amounts on Schedule RCS-7 should
10 be calibrated for the impact of other adjustments that would affect the domestic
11 production percentage or the amount of MAWC's federal taxable income at proposed
12 rates up to and including the ultimate revenue requirement that is authorized by the
13 Commission in its Order in this proceeding.

14 ***C. American Water Works' Decision to not take Bonus Tax***
15 ***Depreciation Because of Parent Company Consolidated Net Operating***
16 ***Loss Carryforwards and Charitable Deduction Carryforwards***
17

18 **Q. HAS MAWC'S PARENT COMPANY, AMERICAN WATER WORKS, MADE**
19 **DECISIONS IN RECENT YEARS CONCERNING NOT TAKING AVAILABLE**
20 **BONUS TAX DEPRECIATION?**

21 **A.** Yes. The parent company elected to not allow MAWC to take bonus depreciation in tax
22 years 2011 and 2013. OPC asked whether MAWC or American Water Works opted out

1 of taking bonus depreciation in any year between 2011 through 2014. The Company's
2 response to OPC 5038 stated:

3 MAWC and American Water Works opted out of bonus depreciation in
4 tax years 2011 and 2013. In 2011, the bonus depreciation allowed by the
5 IRS to deduct was 100% of qualifying property. It was determined that
6 because the consolidated group already had sufficient net operating losses
7 (NOL's), adding to that would jeopardize its ability to use them in the
8 future, even though the carryforward is 20 years. In 2013, the
9 consolidated group had charitable contribution carryforwards that were
10 going to expire unused if the Company was in a taxable loss position.
11 That would have been an additional tax expense to the Company.
12 Therefore, it was decided to opt out of taking the bonus depreciation.

13
14 **Q. WHAT IS THE IMPACT OF THE PARENT COMPANY'S DECISIONS TO NOT**
15 **ALLOW MAWC TO TAKE BONUS TAX DEPRECIATION IN 2011 AND 2013**
16 **ON THE COMPANY'S RATE BASE?**

17 A. The effect of these parent company decisions is that MAWC has a higher rate base, other
18 things being equal. By not taking bonus tax depreciation in 2011 and 2013, the Company
19 had not taken all of the tax deductions to which it was entitled. Bonus tax depreciation,
20 like other forms of accelerated depreciation, results in higher balances of cost-free, non-
21 investor supplied capital in the form of Accumulated Deferred Income Taxes ("ADIT")
22 related to utility plant. Such ADIT balances are a major deduction from utility rate base.

23

1 **Q. WHAT ARE THE CONSEQUENCES TO RATEPAYERS OF AWWC NOT**
2 **ALLOWING MAWC TO TAKE BONUS TAX DEPRECIATION IN 2011 AND**
3 **2013?**

4 A. The consequences of the American Water Works decision to have MAWC opt out of
5 claiming a tax deduction for bonus depreciation in 2011 and 2013, other things being
6 equal, is that MAWC's ADIT balance is lower and its net rate base is higher.
7 Specifically, had the parent, American Water Works, allowed MAWC to take bonus tax
8 depreciation in 2011 and 2013, the impact would have been reflected in the Company's
9 ADIT balance, which in Missouri is reflected as a reduction to rate base. The impact of
10 the parent company's decision to have MAWC opt out of bonus tax depreciation in 2011
11 and 2013 based on concerns over items such as American Water Works consolidated
12 NOL carryforwards and parent company consolidated return charitable contribution
13 carryforwards, would be for MAWC to have a lower amount of ADIT, a lower rate base
14 deduction for ADIT, and a higher net rate base, which is detrimental to ratepayers.

15 **Q. DID THE COMPANY CLAIM BONUS TAX DEPRECIATION IN THE 2014**
16 **TEST YEAR?**

17 A. Yes. According to the response to OPC 5039, for the 2014 test year, MAWC took a
18 bonus tax depreciation deduction in the amount of \$23,628,443. The impact of this

1 deduction increased MAWC's ADIT balance by \$9,229,861,¹⁶ which in turn reduced the
2 Company's rate base by that amount. Similar increases to ADIT and reductions to
3 MAWC's rate base would have occurred for 2011 and 2013 bonus tax depreciation had
4 MAWC been permitted to claim bonus tax depreciation in those years.

5 **Q. COULD MAWC HAVE CLAIMED BONUS TAX DEPRECIATION IN 2011 AND**
6 **2013 EVEN IF SOME OTHER ENTITIES THAT WERE PARTICIPATING IN**
7 **THE AMERICAN WATER WORKS CONSOLIDATED FEDERAL INCOME**
8 **TAX RETURN DECIDED TO "OPT OUT" AND NOT CLAIM BONUS TAX**
9 **DEPRECIATION IN THOSE YEARS?**

10 A. Yes. IRC §168(k)(2)(D)(iii) states that taxpayers are entitled to elect whether or not to
11 take bonus tax depreciation at the legal entity level. Consequently, MAWC could have
12 claimed bonus tax depreciation in 2011 and 2013.

13 **Q. CAN BONUS TAX DEPRECIATION BE IMPUTED IF IT IS NOT TAKEN BY A**
14 **UTILITY?**

15 A. It is my understanding that bonus tax depreciation or other forms of accelerated tax
16 depreciation cannot be imputed for ratemaking purposes, if not taken by the utility on a
17 tax return, due to Internal Revenue Code ("IRC") normalization requirements.

¹⁶ The Company used a blended tax rate of 39.06% to calculate the ADIT impact of the 2014 bonus tax depreciation deduction.

1 **Q. PLEASE EXPLAIN WHY IMPUTING BONUS TAX DEPRECIATION NOT**
2 **TAKEN BY A UTILITY ON A PRIOR YEAR TAX RETURN WOULD VIOLATE**
3 **IRC NORMALIZATION REQUIREMENTS.**

4 A. The IRC requires the use of normalization (i.e., deferred tax accounting) as a requirement
5 to using accelerated tax depreciation. In order for a utility to continue to be able to utilize
6 accelerated tax depreciation, it must comply with the IRC normalization requirements,
7 which require certain elements of consistency in the way that accelerated tax depreciation
8 and deferred income taxes are recognized in the utility ratemaking process. Attempting
9 to impute accelerated tax depreciation that is not taken on a federal income tax return is
10 an inconsistency that would likely result in a violation of tax normalization requirements.

11 **Q. WHAT WOULD BE THE CONSEQUENCES OF THE COMMISSION**
12 **IMPUTING BONUS TAX DEPRECIATION THAT WAS NOT TAKEN BY**
13 **MAWC IN 2011 AND 2013?**

14 A. If the Commission were to impute MAWC's bonus tax depreciation for tax years 2011
15 and 2013, my understanding is that such imputation would violate tax normalization
16 requirements and would result in MAWC losing its ability to use accelerated tax
17 depreciation for federal income tax purposes. Discontinuing the Company's ability to use
18 accelerated tax depreciation, could thus result in MAWC prospectively having a
19 substantially higher rate base in future rate cases, other things being equal.

1 **Q. WHY ARE YOU BRINGING THIS ISSUE TO THE COMMISSION'S**
2 **ATTENTION?**

3 A. The American Water Works decisions to not have MAWC take bonus tax depreciation in
4 some prior years, including tax years 2011 and 2013, could have detrimental long-term
5 impacts on MAWC ratepayers, resulting from lower ADIT balances and higher rate base.
6 Although there may not be a feasible way to adequately or directly remedy this in the
7 current MAWC rate case due to IRS tax normalization requirements, the parent
8 company's tax decisions and their impact on MAWC are something of which a regulatory
9 commission should be made aware. Those American Water decisions were apparently
10 based on an analysis of consolidated federal income tax return issues, such as NOL
11 carryforward and charitable contribution carryforward considerations, and were not based
12 on a detailed separate return analysis of consequences to MAWC or MAWC's ratepayers.
13 In the current MAWC rate case, there is another income tax issue of computing the
14 DPAD for MAWC on a separate return basis. Properly reflecting the impact of the
15 DPAD on a separate return basis for MAWC can help alleviate some of the adverse
16 impacts on MAWC's ratepayers, such as the parent company's decision to not have
17 MAWC claim 2011 or 2013 bonus tax depreciation.

18 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY ON REVENUE**
19 **REQUIREMENT ISSUES?**

20 A. Yes.