

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

In the Matter of the Petition of Missouri-American)
Water Company for Approval to Establish an) **Case No. WO-2018-0373**
Infrastructure System Replacement Surcharge (ISRS)) **Tariff No. JW-2019-0018**

STAFF’S POST-HEARING BRIEF

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

Background

Missouri-American Water Company (“MAWC”) filed its *Petition to Establish an Infrastructure System Replacement Surcharge (“ISRS”) & Motion for Approval of Customer Notice (“Petition”)*, and tariffs associated therewith, on August 20, 2018, in accordance with Commission Rule 4 CSR 240-3.650. MAWC’s Petition requested an adjustment to its ISRS rates and charges for ISRS-eligible infrastructure system replacements and relocations made during the period of January 1, 2018, through September 30, 2018. On August, 23, 2018, the Commission issued its *Order Directing Notice, Setting Intervention Deadline, Directing Filing, and Suspending Tariff*.

Staff filed its *Staff Recommendation* on October 19, 2018, that recommended the Commission issue an Order that: (1) rejects MAWC’s ISRS tariff sheet (YW-2019-0018), P.S.C MO No. 13 10th Revised Sheet No. RT 10 cancelling 9th Revised Sheet No. RT 10, filed on August 20, 2018; and (2) approves the Staff’s recommended ISRS surcharge revenues in the incremental pre-tax revenue amount of \$6,377,082.¹

¹ Staff subsequently amended its recommended ISRS surcharge revenues to \$6,377,959.

MAWC filed its *Response to Staff's Recommendation* on October 29, 2018, specifically objecting to Staff's treatment of net operating losses ("NOLs"). MAWC's *Response* also identified the errant removal of \$9,272 from ISRS revenue requirement by Staff,² and accepted and indicated agreement with *all other portions* of the Staff Recommendation. On November 5, 2018, the Commission issued its *Order Setting Prehearing Conference* setting a prehearing conference for November 15, 2018. After a phone conference between the parties and the regulatory law judge on November 6, 2018, the parties filed their *Joint Proposed Procedural Schedule*. The Commission issued its *Order Cancelling Prehearing Conference and Adopting a Procedural Schedule*, setting an expedited procedural schedule with a hearing scheduled for November 20, 2018. The hearing took place as scheduled, during which the parties presented a total of six witnesses and entered ten exhibits into the record as evidence.

Introduction

Staff filed the parties' joint *List of Issues, List and Order of Witnesses, Order of Cross-Examination and Order of Opening* on November 14, 2018, which presented a single issue to be decided by the Commission, set forth in the Argument section below.

The Commission should recognize that the "rate design" of the ISRS rates, or calculation of the actual ISRS rates, is not contested. Neither the Office of the Public Counsel ("OPC") nor MAWC provided testimony in regard to rate design; only Staff Witness Matthew Barnes testified as to the resulting rates to be charged

² Staff and MAWC are in agreement that the \$9,272, erroneously identified by Staff as investments relating to the replacement of customer owned lead service lines, should not have been removed from MAWC's ISRS revenue requirement.

ratepayers based upon both Staff’s recommended ISRS revenues, and those of the Company. Therefore, Staff’s recommended rate design, and resulting rates, which are set forth on Exhibit 5, is uncontested and should be adopted by the Commission.

Argument

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

No. While Staff generally agrees that any reduction to rate base associated with ADIT must be offset by deferred tax assets related to incurred net operating losses (“NOLs”), in order to reflect the fact that the utility cannot utilize all of the tax deductions available to it for which deferred taxes were booked,³ Staff respectfully recommends that the Commission should NOT reduce MAWC’s ADIT balance in rate base by an imputed NOL in this case. MAWC is projecting that it will be able to reflect all of its net accelerated depreciation benefits associated with ISRS plant additions on its books during the next two years without the need to record any new offsetting NOL amount.^{4,5} As such, Staff recommends the Commission approve Staff’s recommended ISRS surcharge revenues in the incremental pre-tax revenue amount of \$6,377,959, and approve the following rates for each class:

Rate A	\$0.19772
Rate B	\$0.00176
Rate J	\$0.00168 ⁶

³ Ex. No. 3, p. 6.

⁴ *Id.* at p. 7.

⁵ Ex. No. 4, pp. 5-6.

⁶ Ex. No. 5, p. 2.

MAWC filed its *Petition* on August 20, 2018, based on actual ISRS-eligible plant expenditures from January 1, 2018, through July 31, 2018, and estimated investment amounts for August 1, 2018 through September 30, 2018; MAWC updated the August and September investments to include actual numbers while Staff was conducting its audit. After Staff issued its Recommendation, MAWC recognized Staff's recommended exclusions, resulting in a revenue requirement recommended by the Company of \$7,264,876.⁷ This amount is \$886,917 higher than Staff's recommended revenue requirement of \$6,377,959, and results from differing calculations of the amount of deferred income taxes used to offset ISRS rate base.⁸

A. What are Deferred Taxes?

As described by Staff Witness Lisa M. Ferguson, accumulated deferred income taxes ("ADIT"), in effect, represent a net prepayment of income taxes by a utility's ratepayers.⁹ A utility is able to deduct depreciation expense from its taxable income on an accelerated basis. However, for ratemaking purposes, the depreciation expenses utilized to calculate rates are much lower than the depreciation deductions utilized for tax purposes. This results in what is referred to as a "book/tax timing difference," and creates a deferral of income taxes to the future; utilities collect more income tax expense within their rates than they actually pay to the government in a given year.¹⁰ The difference in income taxes paid by the utility and those amounts collected by the utility in rates, are accumulated to recognize future tax obligations, and are a source of interest-free funds for a utility. Both Ms. Ferguson and

⁷ Ex. No. 1, p. 5.

⁸ *Id.*; Ex. No. 4, p. 3.

⁹ Ex. No. 4, p. 3.

¹⁰ *Id.* at p. 4.

Staff Witness Mark L. Oligschlaeger explain in their direct testimonies, that in order to recognize this contribution of interest-free funds from ratepayers, the utility's rate base is offset by that amount of deferred taxes, which in turn reduces the rates ultimately charged to ratepayers.¹¹

B. Deferred Taxes and ISRS

Pursuant to section 393.1000(1)(a), RSMo,¹² the recovery of "Appropriate Pretax Revenues" through an ISRS mechanism must include "recognition of accumulated deferred income taxes." In determining the appropriate amount of ADIT to reflect in ISRS rates, both Staff and MAWC calculated the ISRS-related deferred tax liability of the Company in the same manner;¹³ however, MAWC took the additional step of offsetting that deferred tax liability with a corresponding deferred tax asset, which the Company claims arises from the NOL created by not yet having received revenues related to its incremental ISRS investment. MAWC asserts, as explained by MAWC witness John R. Wilde, that not including this "imputed" NOL could result in a finding by the IRS that the Company violated the tax normalization rules, or that MAWC violated its consent decree allowing it to normalize a repairs deduction,¹⁴ and thus, could result in the loss of significant tax benefits that currently benefit customers.¹⁵

¹¹ *Id.* pg. 4; Ex. No. 3, p. 4.

¹² Commission Rule 4 CSR 240-3.650(1) outlines the identical requirements.

¹³ Ex. No. 4, p. 4.

¹⁴ In 2010, American Water Works Inc. and its subsidiaries requested permission to change their method of accounting for costs associated with routine repair and maintenance of tangible property beginning with the taxable period of January 1, 2008, and is attached to the Direct Testimony of MAWC Witness John R. Wilde as Schedule JRW-1.

¹⁵ Ex. No. 2, p. 9.

However, as Mr. Oligschlaeger explained at hearing, MAWC's proposed inclusion of a hypothetical¹⁶ NOL deferred tax asset in ISRS rate base in this case is not reasonable on its own terms, and is not in any way mandated by the IRS tax normalization rules.¹⁷

C. MAWC Is Not Generating a Net Operating Loss

A "NOL" results when, in a given tax year, a utility does not have enough taxable income to utilize all of the tax deductions to which it would otherwise be entitled. When this occurs, the amount of the unused deductions is booked to a deferred tax asset account.¹⁸ Once a NOL is booked, it can be used as a "carry-forward" amount to offset any positive taxable income amounts in future years. Staff generally agrees that any reduction to rate base associated with ADIT must be offset by deferred tax assets related to incurred NOLs, in order to reflect the fact that the utility cannot utilize all of the tax deductions available to it for which deferred taxes were booked.¹⁹ However, the applicable deferred tax liabilities and deferred tax assets must be related to regulated deductions included in the utility's cost of service.²⁰

In the case at hand, MAWC has taken the position that a NOL amount should be offset against the ADIT balance in rate base for purposes of determining ISRS rates. MAWC witness Mr. Wilde asserts that the incremental ISRS-eligible investments at issue in this case are estimated to generate a taxable loss of \$36.9 million.²¹

¹⁶ As explained on the stand by Staff Witness Lisa Ferguson (Tr. p. 100-101), and later in this brief, by using the term "hypothetical," it is meant that MAWC is calculating a deferred tax asset associated with a NOL for purposes of this ISRS period, while no such NOL deferred tax asset has actually been booked by MAWC.

¹⁷ Tr. p. 87.

¹⁸ Ex. No. 3, p. 5.

¹⁹ *Id.* at p. 6.

²⁰ Tr. p. 96.

²¹ Ex. No. 2, p. 12.

However, NOLs are not calculated on an incremental basis; they are calculated on an overall basis and are not split out for accounting purposes by which specific tax deductions gave rise to a NOL.²² A closer look at MAWC's argument reveals that this "taxable loss" is not, in fact, a NOL generated during the ISRS period at issue at all. Instead, it is an estimate of the reduction to the amount of NOL carry-forward MAWC will utilize in the 2018 tax year, due to ISRS investments.²³ Because MAWC is assuming the existence of a NOL when no such amount is recorded on its books,²⁴ MAWC is, in effect, asking the Commission to impute a hypothetical NOL amount allegedly associated with ISRS plant additions.²⁵

As Mr. Oligschlaeger explained at hearing, MAWC has a NOL deferred tax asset on its books that was generated for a period of time through the end of 2017. That NOL amount was reflected in rate base in MAWC's last general rate case, Case No. WR-2017-0285.²⁶ According to Mr. Wilde, as of December 31, 2017, this NOL deferred tax asset had a balance of \$148.0 million, and MAWC currently estimates that the balance will be reduced to \$92.1 million as of December 31, 2018.²⁷ Given that MAWC's own estimates show that its NOL amounts from prior tax periods are expected to decrease by almost \$56 million, MAWC is not expecting to generate a NOL for the 2018 tax year. This was confirmed at hearing when Mr. Wilde testified that, but for NOL carry-forward amounts from prior tax years, it is expected that MAWC would have taxable income in 2018. Mr. Wilde further confirmed this when he testified that a

²² Tr. p. 98.

²³ Ex. No. 2, p. 13.

²⁴ Tr. pp. 100-101.

²⁵ Ex. No. 3, p. 7.

²⁶ Tr. p. 87.

²⁷ Ex. No. 2, p. 13.

taxpayer cannot utilize a NOL carry-forward amount from a prior tax year without first exhausting all of the deductions available to it for the current tax year.²⁸ Because MAWC anticipates that it will have taxable income for the 2018 tax year, it necessarily follows that MAWC will exhaust all of its available 2018 deductions. Therefore, MAWC is projecting that it will be able to reflect all of its net accelerated depreciation benefits associated with new ISRS plant additions put into service during this ISRS period, without the need to record *any* new offsetting NOL amount.²⁹

While the Company does not expect to generate any new NOLs during the ISRS period at issue, MAWC asserts that it would have been able to utilize *more* NOL amounts from prior tax periods to offset taxable income for 2018 had it not made the ISRS investments at issue in this case.³⁰ However, the fact that MAWC might have been able to utilize more of its NOLs from prior periods in a *hypothetical* situation cannot be considered, in any reasonable way, to be an increase to NOL amounts.³¹

The ISRS period for this proceeding extends from January 1, 2018, through September 30, 2018. Only costs directly associated with qualifying ISRS plant that went into service during those nine months should be reflected in ISRS rates approved in this case. Therefore, the only potentially relevant NOL amounts in this case are those generated by MAWC from January 1, 2018, through September 30, 2018. Because MAWC's own estimates show that no NOL amount is expected to be generated during that timeframe, and because the NOL deferred tax asset balance as

²⁸ Tr. pp. 68-69.

²⁹ Ex. No. 3, p. 7.

³⁰ Ex. No. 2, p. 13.

³¹ Tr. p. 92.

of year-end 2017 is currently reflected in MAWC's base rates, no further rate treatment of that amount is appropriate in this ISRS proceeding.³²

D. MAWC's NOL Calculation Methodology is Flawed

Given the absence of any incurred NOL amount on MAWC's books thus far in 2018, MAWC is actually recommending that a "hypothetical" NOL amount allegedly associated with ISRS plant additions be imputed into rate base.³³ The theoretical basis for this recommendation is that the addition of ISRS plant to MAWC's rate base without immediate receipt of new revenues reduces its taxable income below the level that would result if the ISRS plant addition had not been made. MAWC claims this delays the rate at which MAWC can utilize prior accumulated NOLs as a carry-forward against future taxable income.

To estimate this hypothetical NOL, the Company adds the tax timing difference related to repairs and accelerated depreciation with depreciation expense and interest expense, and then subtracts those reductions from zero.³⁴ This methodology is flawed. As Ms. Ferguson explained in her direct testimony, and again at hearing, in Missouri, direct rate recovery of investment by a utility can only occur after that investment is in service; it must be used and useful.³⁵ If incremental tax deductions associated with new plant investment are applied to zero incremental revenue, a hypothetical net operating

³² Tr. p. 87.

³³ Ex. No. 3, p. 7.

³⁴ Ex. No. 4, pp. 4-5.

³⁵ "The utility property upon which a rate of return can be earned must be utilized to provide service to its customers. That is, it must be used and useful. This used and useful concept provides a well-defined standard for determining what properties of a utility can be included in its rate base." ***State ex rel. Union Electric Co. v. Public Service Commission***, 765 S.W.2d 618, 622 (Mo. App., W.D. 1988).

loss calculation will automatically result in every instance, whether a utility is actually generating a NOL or not.³⁶

As MAWC is not generating or booking any actual NOL during this ISRS period, it is obvious that other factors are causing a situation in which MAWC has enough taxable income to “use” prior amounts of booked NOL in the ISRS period, and is not generating or booking any incremental NOL associated with ISRS plant additions that might need to be taken into account in this ISRS case.³⁷

It is Staff’s opinion, that should a situation arise in the future, where a NOL is generated due to ISRS investment, a different method of calculation will need to be considered in order to appropriately assign a NOL to incremental ISRS investment.³⁸

E. Failure To Impute A Hypothetical NOL Is Not A Violation of the Normalization Rules

As stated above, MAWC argues that the theoretical reduction in taxable income allegedly caused by deductions related to ISRS plant additions made outside of a rate case somehow implicates the tax normalization requirements of the IRS Code; Staff disagrees. Staff’s position on this issue is fully consistent with what it understands to be the intent of the normalization requirements in the IRS Code.³⁹

Staff has found no support for MAWC’s contention that failure to reflect a rate base offset for a “hypothetical” NOL in this case could lead to a normalization violation. Treasury Regulation § 1.167(l)-1 effectively mandates that regulatory commissions normalize the benefits of accelerated tax depreciation tax deductions in setting rates. Further, the rule clearly states that the existence of NOLs can be a relevant

³⁶ Tr. p. 97.

³⁷ Ex. No. 4, p. 5.

³⁸ Tr. p. 97.

³⁹ Ex. No. 3, p. 9.

consideration in specific circumstances when assessing whether a utility is in compliance with the rules. Section 1.167(l)-1(h)(1)(iii) states:

Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of a different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (l) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. **If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (l) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (l) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. (Emphasis Added).**

This section provides that if a new NOL carry-forward would not have arisen (or increased), but for the use of accelerated tax depreciation, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. However, neither of these situations applies to MAWC during this particular ISRS period. As Mr. Oligschlaeger testified at hearing, so far in 2018, MAWC has not generated any new NOL in the aggregate, and as a result, its existing NOL balance has been decreasing, not increasing. Because MAWC is not currently generating any additional amount of NOL, no violation of the tax normalization rules is at risk in this case.⁴⁰ However, should MAWC still have concerns relating to its compliance with the IRS normalization rules, § 1.167(l)-1(h)(1)(iii) effectively directs utilities to obtain private letter rulings (“PLRs”) to determine whether

⁴⁰ Tr. p. 90.

their accounting methodology complies with the normalization requirements; Staff is unaware of any request by MAWC for a PLR on this issue.

While Staff is not aware of any request by MAWC for a PLR on this issue, MAWC witness Mr. Wilde generally referred to certain other PLRs issued by the IRS in recent years as supporting MAWC's NOL position in this case. First of all, it is important for the Commission to understand that a PLR is based on the representations submitted by the requesting taxpayer, and is only valid if those representations are accurate. While PLRs can provide guidance, they are directed only to the taxpayer who requested it, and pursuant to Section 6110(k)(3) of the Federal Code, may not be used or cited as precedent. That being said, none of the PLRs discussed by Mr. Wilde, or attached to his testimony,⁴¹ as supporting MAWC's position are relevant to MAWC's current financial and taxable positions. Without exception, all of the PLRs cited by Mr. Wilde address time periods in which the utility in question was generating NOL amounts,⁴² and were issued in the context of general rate proceedings, or formula rate proceedings, where all relevant factors were taken into account. Again, MAWC is not currently generating any NOL; it is "using" prior amounts instead. Staff is not aware of any PLRs that directly address tax normalization consequences in the situation which a utility is utilizing, not generating, prior tax period NOL amounts.

F. Reflection Of The Repairs Deduction In MAWC's ISRS Is Appropriate

In 2010, American Water Works, Inc., and its subsidiaries requested permission to change their method of accounting for costs associated with routine repair and

⁴¹ Ex. No. 2, Schedule JRW-2: PLR 201718015; Ex. No. 2, Schedule JRW-3: PLR 201709008; Ex. No. 2, Schedule JRW-4: PLR 201436037; Ex. No. 2, Schedule JRW-5: PRL 201519021; and Ex. No. 2, Schedule JRW-6: PLR 201548017.

⁴² Tr. p. 90.

maintenance of tangible property, beginning with the taxable period of January 1, 2008.⁴³ MAWC included the impact of the deduction in its initial Petition.⁴⁴ Staff, in its Recommendation, agreed with the Company's inclusion of the impact related to the repairs deduction in its ISRS calculation.⁴⁵ In its *Response* to Staff's Recommendation, MAWC specifically objected to Staff's treatment of NOLs and identified the errant removal of \$9,272 from ISRS revenue requirement by Staff, however, it accepted and indicated agreement with *all other portions* of the Staff Recommendation. Subsequently, whether the repairs deduction should be reflected in MAWC's ISRS was not included on the *List of Issues, List and Order of Witnesses, Order of Cross-Examination and Order of Opening* filed by Staff on behalf of all parties.

However, at hearing, MAWC offered Exhibit 10 into the record, as an alternative route for the Commission to take.⁴⁶ MAWC Witness LaGrand testified that Exhibit 10 was meant to provide an alternative to Schedule BWL-1, attached to his Direct Testimony,⁴⁷ by removing from MAWC's ISRS calculation both the NOL deferred tax asset utilized by the Company as an offset to ADIT, and the deferred tax liability associated with the repairs deduction. MAWC witness Mr. Wilde stated that other Missouri utilities have filed ISRS petitions without including the effect of utilizing a repairs deduction, and by eliminating it from MAWC's filing, most of the NOL deferred tax asset is eliminated from MAWC's filing as well. The effect of the removal of both of

⁴³ Tr. p. 98.

⁴⁴ Tr. p. 41.

⁴⁵ *Id.*

⁴⁶ Tr. p. 42 & 43.

⁴⁷ Tr. p. 43.

these items, would reduce MAWC's recommended ISRS revenues by approximately \$62,000, and result in a total ISRS revenue requirement of \$7,202,462.⁴⁸

While MAWC's "alternative solution" may appear to be a middle ground, the Commission should not entertain it. First, Mr. Wilde suggested at hearing that by eliminating the deferred tax liability associated with the repairs deduction, the NOL deferred tax asset issue would be eliminated;⁴⁹ this is simply mistaken. While the repairs deduction could be one factor in creating a NOL, as covered at length above, MAWC is not generating or booking any actual NOL during this ISRS period. This is true even with the inclusion of the deferred tax liability associated with the repairs deduction. Second, it is important to note that MAWC has included the repairs deduction in previous ISRS applications.⁵⁰ Further, MAWC witness LaGrand indicated in an exchange with Commissioner Hall that he believed that the repairs deductions are directly associated with qualifying ISRS plant.⁵¹ Finally, while other Missouri utilities have not included the same exact repairs deduction in their ISRS filings as utilized by MAWC,⁵² as explained by Ms. Ferguson on the stand, the deferred tax liability associated with the repair allowance deduction is appropriate to include in ISRS rates because the costs associated with this deduction are incurred to keep the taxpayer's property in ordinary efficient operating condition, and do not materially increase the value of the property or prolong the useful life of the property.⁵³

⁴⁸ Ex. No. 10, p. 1.

⁴⁹ Tr. p. 63.

⁵⁰ Tr. p. 36.

⁵¹ Tr. p. 39.

⁵² Ms. Ferguson testified at hearing (Tr. pp. 103 & 105) that a similar type of repairs deduction was supported by Staff in at least one prior Laclede Gas Company ISRS petition; Case No. GO-2004-0443.

⁵³ Tr. p. 99.

Therefore, it is Staff's position that the effect of the repairs deduction should remain in the calculation of MAWC's ISRS revenue requirement, while the Commission should not reduce MAWC's ADIT balance in rate base by an imputed net operating loss.

Conclusion

For the reasons set forth in this brief and Staff's Exhibits in this case, the Commission should issue an order approving Staff's recommended ISRS surcharge revenues in the incremental pre-tax revenue amount of \$6,377,959.

WHEREFORE, Staff respectfully submits this Post-Hearing Brief for the Commission's consideration.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served by electronic mail, or First Class United States Postal Mail, postage prepaid, on this 27th day of November, 2018, to all counsel of record.

/s/ Mark Johnson