

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

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

**APPLICATION FOR REHEARING
AND
MOTION TO DEFER RULING**

COMES NOW Missouri-American Water Company, and pursuant to §386.500, RSMo., submits its *Application for Rehearing and Motion to Defer Ruling* concerning the *Report and Order* issued by the Missouri Public Service Commission (“Commission”) in the above-captioned matter on June 5, 2019. In support hereof, MAWC states as follows:

INTRODUCTION

1. The Commission’s *Report and Order* thwarts the intent of Congress in creating the normalization rules to provide the utility an interest free source of funds to invest in utility property. (IRS Revenue Proc. 2-17-47 (“Congress enacted the ITC and accelerated depreciation to stimulate investment.”)) The evidence shows that MAWC will have a Net Operating Loss (“NOL”) associated with the eligible infrastructure system replacements made between October 1, 2018 and March 31, 2019. That is, when new revenues are compared to book tax depreciation difference and other items, the Company is experiencing a NOL for both 2018 and 2019 of a little more than \$34 million. MAWC’s calculations are within the meaning of Section 393.1000(1)(a) and the normalization rules, as the NOL reflected by MAWC is calculated expressly and exclusively based upon such eligible plant and the actual ISRS revenues.

2. Staff’s calculation, as adopted by the *Report and Order*, does not accurately reflect the cost-free capital associated with the ISRS plant as it steps outside the bounds of the statute and

“borrows” from MAWC’s base rate revenues to assert that customers have provided the necessary capital. In order for customers to have paid \$9,290,765 of accumulated deferred income taxes (“ADIT”), Staff must impute, or “borrow,” revenues from base rates set in the Company’s last rate case.¹ However, those rates were set on a test year ending December 31, 2017, which did not include any of the ISRS plant investments made in 2018 and 2019.² Essentially, the method adopted by the Commission is double counting those base rate revenues in order to reduce the ISRS revenue requirement.

3. The final arbiter as to this situation is the Internal Revenue Service (“IRS”). MAWC’s request for a private letter ruling concerning the normalization issue was submitted to the IRS on June 5 and June 6, 2019. Should the IRS ultimately find there to be a normalization violation as a result of the Commission’s decision, tax professionals indicate that the consequence of such a violation would be the loss of accelerated depreciation for the Company on a going-forward basis. Those professionals further indicate that the only way to avoid the loss of accelerated depreciation where a normalization violation exists is to have an opportunity to cure such violation – not on a prospective basis, but from the beginning of the violation. The worst result for everyone involved (to include both the Company and its customers) would be an IRS finding of a normalization violation at a point in time when the opportunity to cure has passed. Accordingly, in addition to its rehearing application, MAWC has included a Motion to Defer Ruling. The purpose of that Motion is to provide an opportunity for the party that will have the final word on this issue (the IRS) to provide guidance to MAWC and the Commission.

¹ Tr. 81-83, Oligschlaeger.

² *Id.*

APPLICATION FOR REHEARING

4. The *Report and Order* of the Missouri Public Service Commission is unlawful, unreasonable, unjust, arbitrary and an abuse of discretion for one or more or all of the reasons hereinafter set forth. For the reasons stated in the following paragraphs, the decision of the Commission should be reheard and the *Report and Order* should be amended or superseded to address and correct the matters of error raised by the Company.

5. In MAWC's Infrastructure System Replacement Surcharge Application, the Company included a Deferred Tax asset created by the Net Operating Loss ("NOL") from the ISRS investments that were the subject of its Application consistent with the ISRS statute.³ The Commission concluded that the Company had not presented evidence sufficient to support that it will have a NOL in the ISRS Period,⁴ rejected the tariff sheet filed by MAWC on February 20, 2019⁵, and authorized MAWC to file new tariffs omitting an Deferred Tax asset created by an NOL.⁶ In support of its decision, the Commission states, among other things, that "[a]s MAWC is expected to have taxable income in 2018 and 2019, it is reasonable to conclude that MAWC is not generating an NOL during the ISRS period."⁷ (emphasis added)

6. The Commission's Order disregards uncontroverted evidence in the record showing that MAWC will have a Deferred Tax asset associated with the eligible infrastructure system replacements made between October 1, 2018 and March 31, 2019 (i.e. "during the ISRS

³ Section 393.1000(1)(a), RSMo, (emphasis added) defines "Appropriate Pretax Revenues" as:

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

⁴ Order at p. 12.

⁵ Order at p. 13; Tariff Tracking No. YW-2019-0160.

⁶ Order at p. 13.

⁷ Order at p. 11-12.

period”). The calculation of the Deferred Tax liability and the Deferred Tax asset (Net Operating Loss (“NOL”)) MAWC proposes to reflect are contained in the Direct Testimony of MAWC witness Brian LaGrand.⁸ The Company included depreciation and interest expense that occurred during the ISRS period, as well as accelerated depreciation, and the repairs deduction.⁹ These deductions, taken against little ISRS revenue, create a NOL that is specifically associated with the ISRS investments. This NOL is multiplied by the effective tax rate to determine the Deferred Tax asset to include in rate base. Consequently, the Commission’s finding that there was “not sufficient evidence” of an NOL being generated during the ISRS period¹⁰ is without basis because there is ample evidence in the record showing a NOL from the ISRS investments that were the subject of its Application.

7. As stated above, the intent of Congress in creating the normalization rules is to provide the utility an interest free source of funds to invest in utility property.¹¹ To the extent that the utility does not receive this interest free source of funds (or cost-free capital) because taking the accelerated depreciation deduction causes a taxable loss, that taxable loss needs to be included in (i.e offset against) the Deferred Tax liability so that the customers are not benefiting before the utility company receives the benefits.¹² The normalization rules say that the accelerated depreciation used in the Cost of Service calculation (for current expense) must use the same method and life used in the rate base reduction so as not to have a mismatch of the benefits.¹³

8. The practical effect of the *Report and Order* (i.e., to eliminate the recognition of the Deferred Tax asset, while continuing to reflect the Deferred Tax liability) is inconsistent with

⁸ Exh. 4, LaGrand Dir., Sched. BWL-2.

⁹ Exh. 4, LaGrand Dir., Sched. BWL-2, p. 2 of 7;

¹⁰ Order at p. 12.

¹¹ IRS Revenue Proc. 2-17-47 (“Congress enacted the ITC and accelerated depreciation to stimulate investment.”)

¹² Exh. 1, Wilde Dir., p. 5.

¹³ *Id.*

a normalized method of accounting because the impact of ignoring the Deferred Tax Asset provides customers with the benefit of the tax deduction now, through a lower ISRS rate, even though the Company is unable to benefit from those tax deductions at this time. Any ratemaking order which would jeopardize a public utility's eligibility to utilize accelerated depreciation as permitted by 26 U.S.C.A. § 167(1) would be "unreasonable." See *State ex rel. Empire Dist. Electric Co. v. Public Service Commission*, 714 S.W.2d 623, 631; 1986 Mo. App. LEXIS 4184, 24 (Mo.App. 1986).

9. Further, the Commission's *Report and Order* is inconsistent with the ISRS statutes. The ISRS is a form of single-issue ratemaking that is only concerned with identifying the incremental or isolated revenue requirement related to ISRS eligible plant investments.¹⁴ Staff witness Oligschlaeger agreed that the ISRS statute is only concerned with identifying the incremental or isolated revenue requirement related to ISRS eligible plant investments put into service during the period of time at issue.¹⁵ Because the ISRS is viewed as an exception to the general rule against single-issue ratemaking, the ISRS statutes are viewed by the courts very narrowly.¹⁶ Accordingly, only the items outlined in the statute should be examined – and they should be examined in isolation.¹⁷

10. A plain reading of Section 393.1006(1)(a), RSMo, indicates that MAWC should recover the weighted cost of capital associated with ISRS plant. The rate base in that calculation includes accumulated deferred income taxes ("ADIT"). Both Staff witness Lyons and Oligschlaeger agree the ADIT should be the net accumulated deferred tax balance associated with

¹⁴ Tr. 78, Oligschlaeger.

¹⁵ Tr. 78, Oligschlaeger.

¹⁶ See *PSC v. Office of Pub. Counsel (In re Laclede Gas Co.)*, 539 S.W.3d 835 (Mo. Ct. App. 2017) and *Verified Application & in re Liberty Energy (Midstates) Corp. v. Office of Pub. Counsel*, 464 S.W.3d 520 (Mo. 2015).

¹⁷ Tr. 120, Lyons; Tr. 78-79, Oligschlaeger.

ISRS and that this amount should be representative of interest free capital available to fund these investments. However, ultimately, Staff does just the opposite. Staff calculates an ADIT balance related to ISRS eligible property by assuming additional interest free capital of \$9,290,765 was made available to fund \$66,167,640 of expenditures.¹⁸ Staff acknowledges that customers have not paid ADIT of \$9,290,765, as MAWC has only collected \$4,251,973 of ISRS revenue in 2018 and 2019 to date.¹⁹ The reflection of \$4,251,973 of ISRS revenue is contrary to Finding of Fact No. 25, which states in part that MAWC calculates the NOL by subtracting certain items “from zero revenue generated by the subject ISRS replacements.”²⁰

11. In order for customers to have paid \$9,290,765 of ADIT, Staff must impute, or “borrow,” revenues from base rates which were set in the Company’s last rate case.²¹ However, those rates were set on a test year ending December 31, 2017, which did not include any of the ISRS plant investments made in 2018 and 2019.²² Thus, contrary to the Commission’s Finding of Fact No. 19, MAWC’s Deferred Tax asset IS an NOL resulting from the ISRS replacements during the ISRS period.²³

12. Findings of Fact Nos. 29 and 31 discount the NOL in part because the “the NOL calculated by MAWC for 2018 does not exist because MAWC’s tax return has not been filed” and “MAWC has not filed their claimed \$34 million NOL on any income tax filing.”²⁴ These statements ignore the fact that the Deferred Tax liability (the impact of accelerated depreciation) is similarly dependent on an unfiled tax return. OPC witness Riley agreed that accelerated depreciation is a tax return adjustment and no accelerated depreciation has yet been claimed on a

¹⁸ Tr. 128, Lyons.

¹⁹ Tr. 124, Lyons.

²⁰ Order at p. 7.

²¹ Tr. 81-83, Oligschlaeger.

²² *Id.*

²³ Order at p. 7.

²⁴ Order at p. 8.

tax return for the ISRS plant that is the subject of this case.²⁵ Because of this, Staff witness Lyons has no idea what accumulated deferred income taxes MAWC will have on its 2018 tax return.²⁶ However, the Commission has included those deferred income tax amounts in its calculation of the Deferred Tax liability.

13. Finding of Fact No. 20 states that “only costs directly associated with qualifying ISRS plant that became in-service during the six months of the ISRS Period should be reflected in rates.” However, Staff witness Lyons agreed that when the ISRS is viewed in “isolation,” it is clear the customers through ISRS rates in this case and the prior case have not paid enough revenue to support the deferred tax liability reflected by Staff.²⁷ Thus, Staff assumes that the Deferred Tax liability has been paid by customers from base rates.²⁸ This violates the Section 393.1000(1)(a) requirement that accumulated deferred income taxes be “associated with eligible infrastructure system replacements.” It also violates the principle found in Finding of Fact No. 39, as the Commission’s calculation includes “further rate treatment of ISRS eligible costs . . . incurred prior to 2018 . . . to be included in subsequent ISRS proceedings” through the borrowing of revenues from base rates.

14. Excluding the Deferred Tax asset (i.e. net operating loss) from the ADIT results in Total ADIT of \$9,290,765, and implies an additional \$8,764,652 of interest-free capital became available to MAWC during the ISRS period.²⁹ However, since MAWC is not currently a federal cash taxpayer, this interest-free capital has not been made available to MAWC.

²⁵ Tr. 60, Riley.

²⁶ Tr. 117, Lyons.

²⁷ Tr. 129, Lyons.

²⁸ Tr. 128, Lyons.

²⁹ The difference in these numbers (\$526,112) is the total of lines 7 and 25 of Exh. 4, LaGrand Dir., Sched. BWL-2, p. 1 of 7, and is also described as the Net Deferred Income Taxes on page 2 of 7, line 75 (\$253,833, plus \$272,279).

15. The consequences for violation of the normalization rules are extremely significant. A finding by the Internal Revenue Service during an audit (or as the result of a required self-report by MAWC) that the Company violated the tax normalization rules, or the terms of the IRS consent agreement, could cause the loss of significant tax benefits currently benefiting customers. Specifically, MAWC could lose its ability to claim accelerated tax depreciation deductions and tax repair deductions.³⁰

16. If the Company were no longer able to use accelerated depreciation or take the repairs deduction, it would result in higher rates for customers. Both the repairs deduction and accelerated depreciation allow the Company to expense investments faster for tax purposes than for book purposes. This differential, previously described as a “zero interest loan” from the government, is a reduction to rate base. All else being equal, both the Company’s revenue requirement and the customer’s rates are lower when the Company can utilize this normalized tax treatment.³¹

MOTION TO DEFER RULING ON THIS APPLICATION FOR REHEARING

17. The Commission recognizes the significance that a finding of normalization violation would have in that its *Report and Order* includes the following direction:

Missouri-American Water Company shall file notice with the Missouri Public Service Commission within 10 days the issuance of a conclusion or a statement of violation from the Internal Revenue Service regarding Missouri-American Water Company’s February 1, 2019, letter to the Internal Revenue Service self-reporting a possible violation of its consent order and/or normalization rules.³²

³⁰ Exh. 1, Wilde Dir., p. 9.

³¹ Exh. 1, Wilde Dir., p. 14

³² Order at p. 14.

18. Additionally, counsel for both the Staff and the OPC stated that should Staff's (now Commission's) approach create a normalization violation, they would agree that the amounts identified by MAWC should be added to the ISRS revenue requirement.³³

19. There is no requirement that the Commission rule on this Application for Rehearing by a date certain. Given the issues associated with a normalization violation (no matter how small the Commission may believe the chance that a normalization violation will be found), MAWC requests that the Commission take this Application for Rehearing under advisement and *not* issue a ruling thereon until such time as the Company obtains a private letter ruling from the IRS on whether application of the findings by the Commission for the period in question would cause a violation of tax normalization rules. Such a delay would provide the Commission with an opportunity to cure any normalization violation that might be found to exist as a result of this case. It further would avoid cost and time that would otherwise be expended by MAWC and Staff personnel in the processing of an appeal.

CONCLUSION

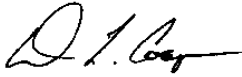
MAWC requests that the Commission defer ruling on this Application for Rehearing until such time as the Company obtains a private letter ruling from the IRS concerning whether application of the findings by the Commission for the period in question would cause a violation of tax normalization rules.

Thereafter, for the reasons stated herein, MAWC respectfully requests that the Commission grant the Company's Application for Rehearing for the reasons aforesaid, and upon rehearing, issue a superseding or correction order directing that ISRS tariffs be filed sufficient to recover ISRS revenues in the amount of \$9,706,228 by including the Deferred Tax Asset in the ISRS

³³ Tr. 26-27, Staff Counsel; Tr. 27-28, OPC Counsel.

calculations and making such other findings as are consistent with the matters set forth above.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I hereby certify that a copy of the above and foregoing document was sent via electronic mail on this 14th day of June, 2019, to:

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