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-2018-0373
Approval to Establish an Infrastructure	)	
System Replacement Surcharge (ISRS).	)	

MAWC'S BRIEF

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

ISSUE

The parties have agreed to the following issue in this case:

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?

DISCUSSION

In addressing the above issue, MAWC's *Brief* will: 1) Describe the accumulated deferred income tax ("ADIT") Asset (Net Operating Loss); 2) Discuss why recognition of a ADIT asset is consistent with the Infrastructure System Replacement Surcharge ("ISRS") statutes; 3) Discuss why failure to recognize the ADIT asset may have significant adverse consequences for MAWC and its customers as a result of the normalization rules and an IRS Consent Agreement pertaining to MAWC; and, 4) Discuss why, in the absence of recognition of the ADIT asset, the Commission should also order that the Repairs adjustment not be reflected in ISRS.

WHAT IS THE ADIT ASSET (NET OPERATING LOSS)?

Before diving into the details of the issue, it may be helpful to describe the ADIT Asset (Net Operating Loss ("NOL")) that is being discussed in this case. Perhaps the best explanation is found in past Commission cases. One such case was a 2015 Commission decision in a Union Electric Company rate case. Therein, the ADIT and NOL (or NOL Carryforward ("NOLC")) were described as follows:

> 2. ADIT represents assets or liabilities for cumulative amounts of deferred income taxes resulting from differences between book accounting and income-tax accounting. For example, tax law sometimes allows a company to claim accelerated depreciation in calculating its taxes.
>
> 3. Since in the short term it pays less in taxes, the company is able to keep more cash. But, because the company can only depreciate its assets once, the accelerated depreciation will reduce the depreciation expense the company would otherwise use to reduce its taxes in future years. Essentially the ADIT allows the company to have the use of "free" cash between the time the ADIT is acquired and the time the increased taxes will come due. Because the ADIT represents "free" cash to the company, ratepayers should not be required to pay for it and the company should not be allowed to earn a return on it. Thus ADIT is removed from the company's rate base.
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> 4. However, <u>when bonus depreciation and other tax deductions grow so large as to push the company's taxable income into the negative, the available tax deduction cannot offset any tax liability and no "free" cash is generated</u>. In that circumstance, the company must record an offsetting deferred tax asset for Net Operating Loss Carryforward (NOLC). The NOLC offsets the ADIT, which would decrease the company's rate base, and therefore, the NOLC has the effect of increasing the rate base.

In the Matter of Union Electric Company d/b/a Ameren Missouri's Tariff, 2015 Mo. PSC LEXIS 380, *22-23, 320 P.U.R.4th 330, ER-2014-0258 (April 29, 2015) (emphasis added).

The concept of NOL was also described as follows later in 2015 in a Kansas City Power & Light Company rate case:

> A net operating loss ("NOL") is created when, in any year, a taxpayer reports more deductions than it has taxable income. Under the generally applicable tax

> rules, an NOL can be carried back two years or forward 20 years. In the year in which it is carried to, an NOL is treated like an additional deduction, reducing the taxable income otherwise produced in that year. When an NOL must be carried forward, a portion of the deductions claimed by the taxpayer in the year that the NOL is created will not offset taxable income and not reduce the taxpayer's tax liability - thus, *no cost-free capital was received for the amount of NOL that did not reduce the tax liability*.

In the Matter of Kansas City Power & Light Company's Request for Authority to Implement a General Rate Increase, 2015 Mo.PSC LEXIS 789, *157, ER-2014-0370 (September 2, 2015) (emphasis added).

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

ADIT ASSET RECOGNITION IS CONSISTENT WITH ISRS STATUTES

Section 393.1000(1)(a), RSMo, 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.

(emphasis added).

The statute specifically calls for "recognition of accumulated deferred income taxes." "Accumulated deferred income taxes include both Deferred Tax Assets and Deferred Tax Liabilities." (Exh. 1, LaGrand Dir., p. 6; Exh. 2, Wilde Dir., p. 4)

Staff generally agrees that "rate base reduction for ADIT must be offset by amounts related to incurred NOLs, to reflect that the companies were not able to currently use all of the

tax deductions available to them and for which deferred taxes were booked" and that "failure to recognize the NOL offset for ratemaking purposes would constitute a violation of the normalization provisions of the IRS Code, by effectively passing accelerated depreciation deduction benefits on to customers prematurely." (Exh. 3, Olisgschlaeger Dir., p. 6) In fact, the balance of MAWC's ADIT Asset (NOL) as of December 31, 2017, was reflected in MAWC's base rates as an offset to the ADIT liability in the Company's last general rate case, Case No. WR-2017-0285. (Exh. 4, Ferguson Dir., p. 5)

The OPC instead argues that "an NOL is a tax return adjustment not a regulatory item." (Exh. 6, Riley Dir., p. 2) As stated above, Staff acknowledges the existence of the NOL and its importance in regard to the normalization rules.

Staff's argument instead revolves around whether the ADIT asset is "associated with eligible infrastructure system replacements." The Staff has argued that the ADIT asset reflected by MWC is "hypothetical" and not directly attributable to the ISRS plant at issue. (Exh. 4, Ferguson Dir., p. 5)

In MAWC's ISRS Application, the Company included a ADIT Asset created by the Net Operating Loss from the subject ISRS investments. This NOL DTA occurs because of the various tax deductions that occur related to those specific investments. The Company included depreciation and interest expense that occurred during the ISRS period, accelerated depreciation, and the repairs deduction. (Exh. 1, LaGrand Dir., Sched. BWL-1, p. 2 of 7; Exh. 2, Wilde Dir., p. 12; Tr. 70, Wilde) These large deductions, taken against no revenue, create a large NOL. (*Id.*) This NOL is multiplied by the effective tax rate to determine the DTA to include in rate base. (*Id.*)

Staff's allegation is based, in part, on its assertion that "MAWC is not generating or booking any actual NOL during the ISRS period." (Exh. 4, Ferguson Dir., p. 5) However, this assertion is not supported by the data Staff cites. In support, Staff witness Ferguson reproduces a MAWC data request response showing the MAWC Deferred Income Tax Asset balance over the period of December 2017, through September 2018. (Exh. 4, Ferguson Dir., p. 6) One can see that the Deferred Income Tax Asset (NOL) balance actually <u>increases</u> between May 2018, and June 2018. (*Id.*) The balance is not always decreasing as alleged by Staff, and NOL <u>is</u> incurred during the period of the ISRS plant at issue.

Staff witness Ferguson acknowledges that ISRS expenditures produce taxable losses (Exh. 4, Ferguson Dir., p.5), and as MAWC witness Wilde explained but for those eligible ISRS Investments the use of the NOLC during that period would have been less (Exh. 2, Wilde Dir., p. 13). In fact, as MAWC witness Wilde points out, when you look at the tax return that will be filed for that period including ISRS, what changes is an increase in total tax deductions driven by ISRS deductions, and a decrease in NOLC utilized increasing the NOLC balance that will be available in future periods which is reflected on MAWC's books as Deferred Tax Asset or DTA, and a component of MAWC's ADIT balance. (Tr. 47, Wilde)Moreover, MAWC witness Wilde explained that the calculation of the ADIT asset (or NOLC) is no more "hypothetical" than the ADIT liability that Staff and OPC are happy to reflect in the ISRS calculation:

> The Company's Application provides a calculation that computes the expected incremental effect that ISRS-eligible investments will have on taxable income or loss, and the incremental effect that ISRS-eligible investments will have on Deferred Income Tax Balances, including the incremental effect that making ISRS-eligible investments will have on the Company's Net Operating Loss Carryover ("NOLC") balance. While based on actual plant expenditures, all of the book to tax temporary timing differences the company provided in its Application are estimates and as such are somewhat hypothetical in nature as they would be in a rate proceeding where tax estimates are provided in advance of a return being

> filed. Staff only attributes the term "hypothetical" to the NOL [ADIT Asset] that they suggest should be excluded from the ISRS rate base, yet this is no more or less an estimate and "hypothetical" than the [ADIT Liability] generated in claiming tax depreciation and tax repairs. The Company's position is the incremental ISRS-eligible investments would generate tax deductions in excess of income generated, so on an incremental basis would generate a tax loss.

(Exh. 2, Wilde Dir., p. 11-12)

Staff further argues that that if MAWC's methodology is used, "the existence of a hypothetical net operating loss will always result from the calculation, whether the utility is actually recording an NOL amount on its books or not." (Exh. 4, Ferguson Dir., p. 5) This is not the case as a company must "be in an NOLC position of an amount greater than the ISRS deductions in order for that to occur on a with and without basis as required by the IRS." (Tr. 48, Wilde)

In a related argument, Staff further suggests that because MAWC shows its NOLC being extinguished by 2020, that there is no NOL associated with the subject ISRS plant. (Exh. 3, Olisgschlaeger Dir., p. 7; Exh. 4, Ferguson Dir., p. 5) However, but for the ISRS investment, MAWC would be expected to be out of its NOLC position earlier than 2020. (Tr. 72, Wilde) There is necessarily an impact on NOL resulting from the subject ISRS plant. (Tr. 71, Wilde)

Including the Deferred Tax Asset as proposed by MAWC is consistent with the ISRS statutes. Staff's adjustment would maintain recognition of the ADIT <u>liability</u>, while eliminating the corresponding ADIT <u>asset</u>. There is no such limitation in the statute, and that approach should be rejected.

IMPACT ON NORMALIZATION ACCOUNTING AND CONSENT AGREEMENT

A failure to include the ADIT asset resulting from Net Operating Losses in MAWC's rate base is inconsistent with a normalized method of accounting and, as such, inconsistent with both the tax normalization rules and a consent agreement MAWC entered into with the Internal Revenue Service ("IRS") in order to allow the utilization of the repairs deduction method.

What are referred to as the "normalization rules" contain one of the few direct interactions between the IRS and decisions by state utility regulatory commissions. Staff witness Oligschlaeger provided the following background describing the normalization method of accounting:

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

(Exh. 3, Olisgschlaeger Dir., p. 3)

In most situations, while a state utility regulatory commission is aware of tax impacts, it would not be required to treat taxes in any particular manner from a ratemaking standpoint.

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

(Exh. 3, Olisgschlaeger Dir., p. 3-4) "In essence, the tax normalization requirements of the IRS Code mandate that utility rates be set so that customers do not receive the tax benefit of accelerated depreciation deductions any faster than over the estimated straight-line book lives authorized for the utilities' assets." (Exh. 3, Olisgschlaeger Dir., p. 4)

In addition to being subject to the existing normalization rules applicable to depreciation, "[i]n 2010, the Company entered into a consent agreement with the IRS which authorized the Company's requested Change in Accounting Method to allow the utilization of the repairs deduction/method." (Exh. 2, Wilde Dir, p. 9) If the Company did not agree to the terms, then it would not have been allowed the additional repairs deductions on its tax returns. (*Id.*) One of the requirements of that consent agreement is that MAWC use a normalized method of accounting, even though a tax repairs deduction is not otherwise specifically subject to that the tax normalization rules. (*Id.* at p. 10)

Staff and OPC's proposal to eliminate the recognition of the ADIT Asset (NOL) is inconsistent with a normalized method of accounting because the impact of ignoring the Deferred Tax Asset provides customers with the benefit of the tax deduction now, via a lower ISRS rate, even though the Company is unable to benefit from those tax deductions at this time. (Exh. 2, Wilde Dir., p. 15-16)

That failure is the key to the normalization rules and the applicability to the ISRS process. As was quoted above:

> When an NOL must be carried forward, a portion of the deductions claimed by the taxpayer in the year that the NOL is created will not offset taxable income and not reduce the taxpayer's tax liability - thus, *no cost-free capital was received for the amount of NOL that did not reduce the tax liability*.

In the Matter of Kansas City Power & Light Company's Request for Authority to Implement a General Rate Increase, 2015 Mo.PSC LEXIS 789, *157, ER-2014-0370 (September 2, 2015) (emphasis added).

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. (IRS Revenue Proc. 2-17-47 ("Congress enacted the ITC and accelerated depreciation to stimulate investment.")) To the extent that the utility does not receive this interest free source of funds because taking the accelerated depreciation deduction causes a taxable loss, that taxable loss needs to be included in the numbers so that the customers are not benefiting before the utility company receives the benefits. (Exh. 2, Wilde Dir., p. 6)

In a private letter ruling, PLR 201548017 (Exh. 2, Wilde Dir., Sched. JRW-6), the IRS representative states as follows in relevant part:

> Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT).

(Exh. 2, Wilde Dir., p. 13-14) (emphasis added)

Similarly, in this case, the rate base is clearly being reduced for deferred taxes as a result of the ADIT Liability. Accordingly, the amount of the NOL Carryforward attributable to

accelerated depreciation should be included as an increase to rate base to offset the decrease from accelerated depreciation.

Staff seems to argue that the normalization rules do not apply here because of the nature of this proceeding as a single-issue rate mechanism. However, there is no authority produced by Staff to support such a limitation. Moreover, it is doubtful that such authority exists or will ever exist. That is because of the before-mentioned purpose of the normalization rules – to provide the utility an interest free source of funds to invest in utility property. Any proceeding, general rate case or otherwise, where the ADIT Liability is recognized, without similar recognition of the ADIT Asset, eliminates that interest free source of funds to invest in utility property and results in a normalization violation. (Exh. 2, Wilde Dir., p. 16)

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. (Exh. 2, Wilde Dir., p. 9)

Such a failure 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 tax treatment." (Exh. 2, Wilde Dir., p. 9)

In response, Staff witness Ferguson suggested at the hearing that any such normalization violation would be non-consequential because of the IRS's "inadvertent error" exception, which

she describes as a “safe harbor.” (Revenue Proc. 2017-47). (Tr. 98, Ferguson) Section 3.02 of the Revenue Procedure cited by Staff witness Ferguson states as follows:

> . . . a taxpayer’s Inconsistent Practice or Procedure is neither inadvertent nor unintentional if the Taxpayer’s Regulator specifically considered and specially addressed the application of the Normalization Rules to the Inconsistent Practice or Procedure in establishing or approving the taxpayer’s rates even if at the time of such consideration the Taxpayer’s Regulator did not believe the practice or procedure was inconsistent with the Normalization Rules.

There is no “safe harbor” for the situation with which the Commission is presented.

IN THE ABSENCE OF ADIT ASSET RECOGNITION, THE COMMISSION SHOULD NOT REFLECT THE REPAIRS DEDUCTION

Staff witness Ferguson described the use of the ADIT Asset to off-set the deferred tax liability as an “extra step.” (Exh. 4, Ferguson Dir., p. 3) However, it is MAWC’s use of a repairs deduction in its filing (something MAWC added to provide a complete picture along with the ADIT asset (NOL)) that is the extra step in this process.

No other company using the Missouri ISRS over the past four years (i.e., gas utilities) has ever reflected a repairs deduction. (Tr. 24, LaGrand) Staff did not dispute this assertion and the only example it had of a time the Staff may have suggested that a repairs deduction should have been reflected was a 2004 gas ISRS case (Case No. GO-2004-0443). (Tr. 103, 105, Ferguson) A review of Case No. GO-2004-0443 reveals that the issue in that case was not the calculation of appropriate ADIT, but rather an income tax issue.[1] (Direct Testimony of Stephen M. Rackers, Case No. GO-2004-043, EFIS Item 10 (Filed April 26, 2004). The “263(a)” deduction referenced by Staff witness Ferguson and alleged to be an equivalent of the repairs deduction (Tr. 103, Ferguson) is identified by the Staff witness in GO-2004-0443 as “Internal Revenue

[1] See Section 393.1000(1)(b), RSMo.

Code (IRC) Section 263A transfers." (Direct Testimony of Stephen M. Rackers, Case No. GO-2004-043, EFIS Item 10, p. 3 (Filed April 26, 2004). A Laclede witness in Case No. GO-2004-0443 provided the following example of a Section 263A matter:

> One example of such cost is Administrative and General salaries and expenses, which are capitalized on the books to a greater extent than required in the tax code.

(Rebuttal Testimony of James A. Fallert, Case No. GO-2004-0443, EFIS Item 17, p. 4 (Filed May 20, 2004). Bottom line, the GO-2004-0443 issue referenced by Staff witness Ferguson was not a "repairs deduction," and no impact on accumulated deferred income taxes was addressed in Case No. GO-2004-0443.

No other company has reflected the repairs deduction in its ADIT calculation because doing so is not required by the statute. The ISRS statute requires "*recognition of accumulated deferred income taxes*." (Section 393.1000(1)(a), RSMo) Staff witness Ferguson describes "accumulated deferred income taxes" as follows:

> Q. Please explain what accumulated deferred income taxes are and how they are determined.
>
> A. A utility's deferred tax reserve balance represents, in effect, a net prepayment of income taxes by a company's customers in rates prior to actual payment to the taxing authorities. MAWC may deduct depreciation expense on an accelerated basis for income tax purposes. Depreciation expense used for income taxes paid by MAWC is higher than depreciation expense used for rate making purposes. This results in what is referred to as a "book-tax timing difference," and creates a deferral of income taxes to the future.

(Exh. 4, Ferguson Dir., p. 3-4). The portions of OPC's Exhibit 9 emphasized by OPC also refer to comparisons of "the depreciation deduction otherwise appropriate and allowable for tax purposes according to the straight line or other nonaccelerated depreciation method and appropriate useful life for such property." (Exh. 9, p. 72)

Repairs are not "depreciation" (Tr. 103, Ferguson) and should not be a part of accumulated deferred income taxes. For the same reason, they are not "accumulated depreciation." There is no aspect of Section 393.1000(1)(a), RSMo, requiring the use of the Repairs deduction in computing appropriate pretax revenues.

MAWC's reflection of a repairs deduction in the ISRS filing has a direct impact on the necessity of the Deferred Tax Asset resulting from the Net Operating Loss. (Exh. 1, LaGrand Dir., Sched. BWL-1; Exh. 10) If the Commission chooses to not reflect the ADIT Asset (the NOL), it should also not reflect the repairs deduction.

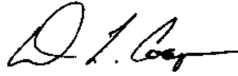
As MAWC witness Wilde explained, ISRS tax deductions primarily made up of tax repair deductions cannot generate additional tax cash flow, and therefore cannot change the balance of the interest free loan, because taxable income would be zero during the measurement period regardless of if MAWC had engaged in ISRS eligible investments or not. (Exh. 2, Wilde Dir., p. 8) Doing so imputes a balance of interest free capital into the ISRS rate base,that will have been financed with debt and equity denying MAWC recovery of those costs. (Tr. 64, Wilde)

Exhibit 10 provides the calculation of the revenue requirement if neither the Repairs deduction, nor the ADIT Asset are reflected. (Tr. 26, LaGrand) In that circumstance, MAWC's revenue requirement for purposes of this ISRS would be $7,202,462. (Tr. 24, LaGrand; Exh. 10, p. 1 of 7)

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

consideration.

Respectfully submitted,



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CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing document was sent by electronic mail or by U.S. Mail, postage prepaid, on November 27, 2018, to the following:

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