Exhibit No.:	________________
Issue(s):	ISRS Revenue Calculations/ NOL in Rate Base
Witness/Type of Exhibit:	Riley/Direct
Sponsoring Party:	Public Counsel
Case No.:	GR-2024-0106

DIRECT TESTIMONY

OF

JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

LIBERTY UTILITIES (MIDSTATES NATURAL GAS) CORP. D/B/A LIBERTY UTILITIES'

CASE NOS. GR-2024-0106

July 18, 2024

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LIBERTY UTILITIES (MIDSTATES NATURAL GAS) D/B/A LIBERTY

CASE NO. GR-2024-0106

Q. What is your name and what is your business address?

A. John S. Riley, PO Box 2230, Jefferson City, Missouri 65102.

Q. By whom are you employed and in what capacity?

A. I am employed by the Missouri Office of the Public Counsel ("OPC") as a Utility Regulatory Supervisor.

Q. What is your educational background?

A. I earned a B.S. in Business Administration with a major in Accounting from Missouri State University.

Q. What is your professional work experience?

A. I was employed by the OPC from 1987 to 1990 as a Public Utility Accountant. In this capacity, I participated in rate cases and other regulatory proceedings before the Public Service Commission ("Commission"). From 1994 to 2000 I was employed as an auditor with the Missouri Department of Revenue. I was employed as an Accounting Specialist with the Office of the State Court Administrator until 2013. In 2013, I accepted a position as the Court Administrator for the 19th Judicial Circuit until April 2016 when I joined the OPC as a Public Utility Accountant III. I have also prepared income tax returns, at a local accounting firm, for individuals and small business from 2014 through 2017.

Q. Are you a Certified Public Accountant ("CPA") licensed in the State of Missouri?

A. Yes, I am. As a CPA, I am required to continue my professional training by attending Missouri State Board of Accountancy qualified educational seminars and classes. The State Board of Accountancy requires that I spend a minimum of 40 hours a year in training that continues my education in the field of accountancy.

Q. Have you previously filed testimony before the Missouri Public Service Commission?

A. Yes, I have. A list of my case filings and certification is attached as JSR-D-1.

Q. What is the purpose of your direct testimony?

A. My testimony will focus on the correct rate of return ("ROR") to apply when calculating revenue requirement for an Infrastructure System Replacement Surcharge ("ISRS"). Then, I will highlight Midstates Natural Gas's ("Midstates" or "Company") lack of a sufficient explanation to justify inclusion of a deferred tax asset in rate base and explain why that is a concern in this case.

ISRS PRETAX REVENUE CALCULATIONS

Q. Are you proposing the Commission change its treatment of ISRS revenues in this case?

A. In my view, the Commission should revise its calculation of Midstates' ISRS revenues. I believe the ISRS revenue calculations are producing an overcollection that should be addressed in this general rate case so the collections can be more accurate in ISRS interim rate cases going forward.

Q. Could you provide an overview of the ISRS process?

A. The ISRS is a surcharge that the Commission determines after an interim rate case procedure. This process allows a gas utility to adjust tariffs and collect additional revenues to address expenses and capital costs for the replacement of "existing facilities that have worn out or are in deteriorated condition[.]"[1] It is a rate relief mechanism that occurs between general rate cases to allow a utility to begin recouping investment for its assets sooner than traditional general rate cases. Revenue recognition for this interim rate case is limited to a handful of ISRS-specific expenditures and taxes, which are then multiplied by the Company's weighted cost of capital.

Q. What is the source of the overcollection in this case?

A. The overcollection is from the federal and state income tax the Company included in the new revenue calculations.

Q. The ISRS statutes specifically include income taxes as a recoverable cost. How are taxes being overcollected?

A. The statutes clearly state which costs are to be recovered. Statute 393.1009 outlines what is included to produce the necessary additional operating income:

> **393.1009. Definitions.** — As used in sections 393.1009 to 393.1015, the following terms mean:
>
> (1) **"Appropriate pretax revenues"**, the revenues necessary to produce net operating income equal to:
>
> (a) The gas corporation's weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system replacements which are included in a currently effective ISRS; and

[1] Missouri Statute 393.1009(5)(a).

<u>(b) Recover state, federal, and local income or excise taxes applicable to such income; and</u> (Emphasis added)

<u>(c) Recover all other ISRS costs.</u>

Appropriate pretax revenues recover taxes that are applicable to such income. In this case, there is no income tax *applicable* to the ISRS income and, therefore, calculating and including income tax in the ISRS revenues results in overcollection.

Q. Reviewing your Statute quotation from above would indicate multiplying the ISRS revenues by the composite tax rate will produce the standard rate case tax amount. This seems to be a straightforward application. What do you base your assertion that there are no applicable taxes?

A. First, for a general rate case, Staff calculates income tax based on the entire revenue and expense of the rate case. The income tax is annualized based on the case as a whole due to the Court's view that the partial calculation of income tax is not an accurate representation of those taxes.[2] The issue is that Staff must determine a utility's taxable income, i.e., the difference between deductions and gross income,[3] to calculate its income tax. However, gross income can only be derived from the revenue of the entire tax year or test year, which prevents income taxes for an interim case to be calculated accurately. Therefore, income tax expense cannot be calculated on a portion of a company's revenues without including the corresponding expenses.

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[2] *Mo.-American Water Co. v. Office of the Pub. Counsel (In re Mo.-American Water Co.)*, 637 S.W.3d 121, (Mo. App. W.D. 2021) (JSR-D-02).
[3] Missouri-American Water Company, Case No.WO-2020-0190 ISRS, John A. Clizer (#69043) Brief.

Second, through Company witness testimony,[4] answers to Staff data requests[5], and available financial filings; the Company has shown that it is not liable for current income taxes, nor does it expect to be liable for these taxes going forward. If Midstates does not owe any taxes, then there are no taxes to recover in interim rates. So, income tax expense does not apply to the ISRS revenues.

Q. Could you provide a definition for a Net Operating Loss ("NOL")?

A. An NOL is a tax return creation where upon a company has calculated, for the income tax return, a higher amount of deductions than its gross revenues.

Q. Is it accurate to suggest that an NOL would negate an interim income tax expense?

A. Yes. An annual Net Operating Loss would indicate no annual taxable income which would negate an interim income tax expense. Also, the Internal Revenue Service ("IRS") does not require interim tax calculations to satisfy any normalization requirements.

Taking that analysis one step further, to include taxes in the ISRS revenues and then include those revenues in the current case would in essence be double dipping on the tax calculations because Staff will calculate income tax on the whole amount (including the ISRS) of rate case income.

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[4] Company witness Mr. Michael McCuen testifies that Liberty is in an ongoing net operating loss ("NOL") carryforward which would indicate that no current income tax is due.
[5] Staff Data Requests No. 0182 & 0334 indicates that the Company expects to be in a no tax situation for the foreseeable future.

Q. How should the Commission consider the inclusion of income tax in the ISRS?

A. The ISRS legislation was fashioned as an attempt to collect a legitimate expense created by additional revenues produced by the ISRS rate of return.[6] However, any company in an NOL situation should not pay income tax on an interim period and therefore should not be collecting tax on an interim basis. Midstates is certainly in this situation. Interim income taxes are calculated by applying what is referred to as a "pre-tax" WACC to the ISRS revenues. This is the Commission accepted cost of capital with a tax gross-up included. The Commission can easily correct this ISRS miscalculation by ordering additions based on the after-tax Cost of Capital and not the pre-tax WACC.

Q. With this analysis in mind, do you have any recommendations for how the Commission should treat Midstate's ISRS revenues?

A. Due to the inclusion of income tax in the Company's last ISRS case, Midstates was allowed to over-collect on the revenues it was due. I recommend the Commission exclude an interim income tax calculation in this case and in future ISRS cases, because the Staff accounting schedules will incorporate all the normalized tax that will be necessary to make the Company revenue requirement complete.

NOL BALANCE IN RATE BASE

Q. Does the definition of "NOL" that you provided in the previous section carry forward into this portion of your testimony?

A. Yes.

[6] The same holds true for WISRS legislation.

Q. Could you provide a definition of ADIT?

A. Accumulated Deferred Income Tax is the calculated timing difference between what deductions are employed in income tax calculations and those used in ratemaking.

Q. Is an NOL considered ADIT?

A. Yes. NOL is referred to as a deferred tax asset because the ability to apply it to taxes at a later date is a value to the company, however, for this testimony I will refer to NOL and ADIT as separate descriptions.

Q. When considering rate base implications, do deferred tax assets and deferred tax liabilities offset each other?

A. Not exactly. The tax asset (NOL) increases rate base, and the tax liability (ADIT) reduces rate base. These two concepts are characteristically different and should not be viewed in combination to produce one number to apply to rate base.

Q. What are the differences?

A. ADIT is calculated by multiplying the net tax timing difference by the tax rate. An example: $1000 in tax depreciation less $500 in straight line regulatory depreciation leaves $500 multiplied by a 21% tax rate creates $105 in ADIT. The customer pays this $105 in advance through rates. This is the interest free loan.

The NOL, for purposes of rate making, is created by a stroke of legislation. An NOL example: Company has $1000 in revenues but $2000 in expenses for income tax purposes. Company has an NOL of $1000. An NOL in itself is not a product of additional spending, but an IRS allowed adjustment to existing cost allocations

(Accelerated depreciation v. straight-line). Current NOLs are not amortized. NOLs are an offset waiting to be applied to future taxable income as needed.

ADIT, as we know it, is an *interest free loan* from the ratepayer, for the purpose of paying taxes due in the future. I believe that characteristic is a huge difference. That is *real money* provided by customers and, therefore, is a deduction from rate base to compensate the ratepayer for the loan. ADIT is generally asset specific and is amortized over an extended period.

Q. What amount of NOL has the Company included in its rate base for this rate case?

A. That isn't exactly clear. Company witness Mr. Michael McCuen has included schedules to his direct testimony and workpapers that indicate that Midstates has included $37,520,757 of NOL in rate base. However, all indications are that $12,949,593 is the accurate rate base inclusion.

Q. Do you feel confident that that either the $37,520,757 or the $12,949,593 are accurate?

A. No.

Q. Please explain.

A. Tracing back from the schedules to the workpapers shows that Mr. McCuen has a Net Operating Loss tab titled MO-5 NOL. The Excel workpaper displays taxable income losses for 2012 through 2017, with an additional CIAC adjustment of $664,017. This column displays $53,745,669 in losses. Mr. McCuen then applies an allocation factor of 69.812% to produce the $37,520,757, yet nothing is recorded for 2018 through 2022. I sent a data request to the Company asking for documentation to substantiate the annual taxable loss claims; however, the Company filed an objection to the request and never provided any requested documentation. (Schedule JSR-D-03).

Q. How has the Company responded to Staff data requests concerning NOL in rate base?

A. Midstates has yet to provide a definitive answer as to the NOL amount that they have included in rate base. Mr. McCuen writes extensively on including NOL in rate base and has Schedules attached indicating that the Company has $37 million in adjustments, however, as I pointed out earlier, that number only coincides with the end of 2017. The Company's answer to Staff data request 183 (Schedule JSR-D-04), where Staff asked if a NOL was included in rate base, was the following:

> The Company's revenue requirement calculation does not include a net operating loss regulatory asset. However, the Company has a Deferred Tax Asset associated with its NOL. The NOL Deferred Tax Asset is recorded with the other deferred tax assets and is not isolated specifically. The Deferred Tax Asset balances are recorded in FERC account 190. The Company has included FERC accounts 190 within its revenue requirement calculation (netted against FERC accounts 282, 283)

It seems that I must be missing something in the audit trail as I can only find incomplete calculations of the Company's NOL carryforward.[7] Then, the Company states that an NOL regulatory asset was not included separately *but* has been lumped with a "Deferred Tax Asset".

Q. What amount of Deferred Tax Asset has Midstates included in revenue requirement?

A. The workpaper titled "WP 3.10 ADIT" indicates that $12,949,593 is included as an Acct. 190 deferred tax asset.

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[7] E.g., The losses from one year that Midstates is able to "carry forward" and deduct from future years' profits.

Q. Since this case began, Midstates has provided data request answers concerning NOL and workpapers producing various NOL balances that are greater than the $12,949,593. So where did this deferred tax asset originate?

A. I was not able to find any testimony or workpapers that assembled this number. These NOL balances do not appear prior to the 2022 test year. My hope is that the Company will be able to provide some discovery after this testimony is filed.

Q. In light of this lack of substantiation, what action do you believe the Commission should take concerning the addition of an NOL or the Deferred Tax Asset in rate base?

A. It is the responsibility of the filing party to substantiate its revenue requirement. In this case, Midstates has not provided evidence to corroborate its claims and I cannot justify the inclusion of the Deferred Tax Asset due to lack of evidence. Thus, The Commission should disregard the inclusion of an NOL or Deferred Tax Asset in rate base.

Q. Does this conclude your direct testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Request of Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty to Implement a General Rate Increase for Natural Gas Service in the Missouri Service Areas of the Company	)))))	Case No. GR-2024-0106

AFFIDAVIT OF JOHN S. RILEY

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

John S. Riley, of lawful age and being first duly sworn, deposes and states:

1. My name is John S. Riley. I am a Utility Regulatory Supervisor for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my direct testimony.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

John S. Riley
Utility Regulatory Supervisor

Subscribed and sworn to me this 17th day of July 2024.

TIFFANY HILDEBRAND
NOTARY PUBLIC - NOTARY SEAL
STATE OF MISSOURI
MY COMMISSION EXPIRES AUGUST 8, 2027
COLE COUNTY
COMMISSION #15637121

Tiffany Hildebrand
Notary Public

My Commission expires August 8, 2027.