

Exhibit No.: _____
Issue(s): NOL Exclusion/Asset Dispositions/
Hedging
Witness/Type of Exhibit: Riley/Surrebuttal
Sponsoring Party: Public Counsel
Case No.: ER-2024-0189

SURREBUTTAL TESTIMONY

OF

JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

**EVERGY MISSOURI WEST, INC. D/B/A
EVERGY MISSOURI WEST**

CASE NOS. ER-2024-0189

** _____ **
Denotes Confidential Information that has been redacted.

September 10, 2024

PUBLIC

TABLE OF CONTENTS

Testimony	Page
NOL Exclusion from Rate Base	2
Tax Benefits from Asset Dispositions	9
Hedging Losses	12

SURREBUTTAL TESTIMONY

OF

JOHN S. RILEY

EVERGY MISSOURI WEST

CASE NO. ER-2024-0189

1 **Q. What is your name and business address?**

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

3 **Q. Are you the same John S. Riley who prepared and filed direct testimony in this case on**
4 **behalf of the Office of the Public Counsel?**

5 A. Yes.

6 **Q. What is the purpose of your surrebuttal?**

7 A. I will be responding to Company witness Ms. Melissa K. Hardesty and Staff witness Mr.
8 Mathew R. Young concerning Net Operating Loss (“NOL”) inclusion in rate base and the tax
9 benefits of asset disposition. I will also be responding to Company witness Ms. Brooke
10 Mastrogiannis concerning hedging expenses being included in the Cost of Service or in the
11 Fuel Adjustment Clause (“FAC”). To summarize: (1) Evergy’s nonexistent NOL balance
12 should not be included in rate base, (2) the tax benefit of asset disposition should be
13 recognized and flown through to the ratepayer, and (3) the cost of hedging should be the
14 responsibility of the Company and should be excluded from both the cost of service and the
15 FAC.

1 **NOL EXCLUSION FROM RATE BASE**

2 **Q. Both Ms. Hardesty and Mr. Young seem to have the same reason for including a Net**
3 **Operating Loss in the calculation of the balance of excess Accumulated Deferred Income**
4 **Taxes (“ADIT”) within rate base. Could you explain the reason?**

5 A. Essentially, the two witnesses contend that since the Company *had* an NOL balance at the
6 time of the change in tax rates from 35% to 21% due to the Tax Cuts and Jobs Act (“TCJA”),
7 the NOL balance is now amortized at the same rate as the excess deferred tax liability. Ms.
8 Hardesty states:

9 The balance is related to the reduction of the federal corporate income
10 tax rate in 2017 from 35% to 21% and for the reduction of the Missouri
11 corporate income tax rate from 6% to 4%, for NOLs that EMW had at
12 that time of the rate changes. The difference in the tax rates was not
13 written off, instead an adjustment to the balances of EMW’s ADIT
14 assets and liabilities was computed and deferred into a regulatory asset
15 or liability to be amortized back to customers over time.¹

16 Mr. Young states:

17 A. Although EMW has exhausted its balance of NOLC from
18 regulated operations, EMW’s regulated books carried a NOLC when
19 the TCJA became law on January 1, 2018.²

20 **Q. Please explain how “excess ADIT” was created.**

21 A. When the tax rates were lowered from 35% to 21%, the ADIT created at the 35% rate would
22 now flow back at the 21% rate so the difference between 35% and 21% would be lost. This
23 difference is the excess ADIT.

¹ Hardesty rebuttal, page 4, Lines 15 - 20

² Young rebuttal, page 3, Lines 10-11

1 **Q. Since this “difference” would never flow back (assuming tax rates would not change),**
2 **what did the Commission decide to do?**

3 A. Because the excess ADIT was an interest free loan from the ratepayer to pay future taxes, the
4 Commission recognized that there is no longer a tax liability and the funding should be
5 returned to the ratepayers.³ The Internal Revenue Service (“IRS”) determined that excess
6 ADIT should return no faster than regular ADIT so the amortization (return) of the balance
7 will be spread over the life of the assets that are associated to the excess ADIT. This really
8 isn’t any different than the treatment of regular ADIT other than it has been identified and
9 separated. So, there are now two ADIT balances being amortized in rates, one for the standard
10 accumulating deferred income tax and other for the excess ADIT.

11 **Q. You mentioned the NOL balance in the past tense. Does EMW have a current**
12 **regulatory NOL balance to offset excess ADIT?**

13 A. No. As I pointed out in direct testimony, the NOL balance is associated to the former
14 company, Aquila, and dates back to 2006 and 2005. Even Staff witness Young acknowledges
15 that the Company no longer has a regulatory NOL on the books.⁴

³ Mathew Young stated in rebuttal that the “deferred tax liability was effectively forgiven by the federal government.”

⁴ Young rebuttal, page 3, lines 10 and 11.

1 **Q. So the crux of this issue is that there *was* a regulatory NOL balance at the time TCJA**
2 **changed tax rates so therefore the Company and Staff are treating the amount as if it is**
3 **excess deferred income tax and amortizing it at the same rate as the ADIT?**

4 A. Yes. It's like the account that time forgot. Both Mr. Young and Ms. Hardesty point to a
5 Stipulation and Agreement from 2018 as the bases of this accounting departure.⁵ EMW
6 managed to insert an "NOL amortization using ARAM provision" into that agreement and
7 Staff feels obliged to follow that Stipulation even though the ARAM is an incorrect
8 accounting methodology for an NOL and a violation of tax rules imposed by the IRS. As a
9 result, an amortized NOL balance is still floating around out in some regulatory wasteland
10 even though all three parties acknowledge that the NOL no longer exists and is therefore no
11 longer able to offset rate base. It should be noted that the OPC did not agree to this Stipulation
12 and Agreement.

13 **Q. You have used the term ARAM several times now. Could you provide a brief**
14 **explanation of what that term means?**

15 A. ARAM stands for Average Rate Assumption Method. Is an amortization method that the IRS
16 has imposed on the disposition of ADIT through rates. The quick and easy description is that
17 the ADIT created by the purchase of a depreciable asset will not be amortized through rates
18 any faster than the expected life of the asset. Say, the purchase of a generator with a useful
19 life of 10 years created \$1000 in ADIT. That ADIT cannot be amortized any faster than the
20 10 years so the ADIT offset will be \$100 annually. Usually, the asset life will be 30-45 years.

⁵ Case NO. ER-2018-0146, Item 262, non-unanimous (because OPC didn't not agree) partial stipulation and agreement 9-19-2018, page 7, paragraph 12

1 **Q. Why is the use of ARAM in amortizing an NOL an incorrect method?**

2 A. First, let's understand that just because a stipulation was signed more than five years ago
3 doesn't mean the premise of that stipulation is still valid. Amortizing a nonexistent NOL is a
4 violation of the normalization rules set out by the IRS and also an abuse of several accounting
5 principles.

6 Secondly, an NOL, even though it is associated to deferred taxes, is not the same as ADIT so
7 the tax rate change that caused the recalculation of ADIT into two accounts, regular ADIT
8 and excess ADIT, does not apply to an NOL. An NOL does not get locked in time with the
9 excess ADIT. Let's understand the fundamental difference in the two.

10 An ADIT balance represents an amount of tax to be paid in the future which is provided, in
11 advance, by the ratepayer. It is a calculated amount of prepaid tax. An NOL is just an
12 adjustment to taxable income on a tax return. It is generated irrespective of a tax rate, which
13 means that an NOL is only a dollar amount, not a tax amount. When the tax rates changed
14 from 34% to 21%, this did nothing to devalue the NOL. The dollar balance is adjusted by
15 each tax return, not by a proposed amortization schedule.

16 As I pointed out in direct testimony, Ms. Hardesty stated that NOLs do not reverse over the
17 remaining life of the assets (which is the basis for why ARAM is used for ADIT) but are used
18 to offset tax liabilities as they present themselves on the tax return.⁶

19 **Q. Please provide an example of how an NOL is created and applied.**

20 A. For tax purposes a utility has \$1 million in revenues. Its taxable expenses, which can be
21 deducted from taxable income on the utility's tax return, amount to \$1.2 million dollars. After

⁶ Riley direct, Page 6, lines 6-16

1 subtracting the \$1.2 million in expenses from the \$1 million in revenue, the taxable income
2 on the return is a loss of \$200,000. There are two tax benefits for the utility from reporting
3 this taxable loss. First, the utility has no income on which to pay taxes and hence pays no
4 taxes. Second, the IRS allows this NOL of \$200,000 to be carried forward and applied as a
5 deduction to revenues in future tax years. Does it make any difference that this NOL was
6 generated when tax rates were 35%? No. It is the difference between taxable revenues and
7 taxable expenses.

8 Let us say the following year the tax rate changes to 21% and the utility earns \$300,000.
9 \$200,000 of the NOL carryforward (“NOLC”) is applied to the \$300,000 and the company
10 has \$100,000 in taxable income. Company pays $\$100,000 \times 21\% = \$21,000$ in tax. If the
11 tax rate wouldn’t have changed, the company would have paid $\$100,000 \times 35\% = \$35,000$.
12 Is it proper accounting or IRS methodology to hold \$14,000 (the difference between the two
13 possible tax liabilities) in some sort of suspension account? Absolutely not. This is nothing
14 more than an adjustment to net income that happened to occur at a tax rate change.

15 **Q. Ms. Hardesty attempts to bolster the validity of ARAM amortization of NOL by stating**
16 **“the Commission determined that the NOL EDIT should be amortized using the IRS’s**
17 **average rate assumption method (“ARAM”) to match the amortization methods used**
18 **for EDIT related to the depreciation deductions that generated the NOL’s”⁷. How do**
19 **you respond to her testimony?**

20 A. First, the fact still remains that the proper application of the Company NOL has reduced it to
21 zero. Moreover, the Commission didn’t “determine” anything. This was a Stipulation and
22 Agreement between Company and Staff and the Commission approved the agreement within

⁷ Hardesty rebuttal, page 5, lines 6-8

1 the 2018 case⁸.The Commission is not bound by this agreement especially since the object in
2 question does not exist anymore.

3 Secondly, the Commission recognizes that NOLs are a tax return item that are not asset
4 specific⁹ This is much different than Hardesty’s attempt to attach the ADIT and NOL as if
5 they are inseparable. ADIT is very much asset specific which is a calculated tax amount
6 outside of a completed tax return.

7 Finally, both Hardesty and Young imply that the IRS is in full agreement with amortizing an
8 NOL by ARAM, yet no one is presenting a legitimate ruling to defend their position. This is
9 clearly wrong. The amortization of a nonexistent NOL by ARAM is a violation of the IRS’s
10 normalization rules.

11 **Q. Can you briefly explain what the IRS normalization rules are.**

12 A. In an effort to increase investment by utilities, the government created tax advantages by way
13 of accelerated depreciation. In order to prevent regulators from stripping the utility of these
14 tax advantages, thereby defeating the purpose of the deduction, the IRS prevented the flow-
15 through of this enlarged deduction and restricted the return of the deduction over the life of
16 the purchased asset. The normalization rules basically instructed the regulators to calculate
17 the income tax expense without consideration of accelerated depreciation. This allows the
18 company to collect taxes expense money from the ratepayer prior to the taxes coming due and
19 controlling the extra funds until the taxes came due several decades later.

⁸ Quote from Order Approving Stipulations and Agreements: “After reviewing the four Stipulations, the Commission independently finds and concludes that they are a reasonable resolution of the issues, and that approval of them will result in just and reasonable rates. Thus, the Commission approves the four Stipulations.”

⁹ Missouri American Water Company, ISRS Case No. WO-2019-0184

1 **Q. How does the non-existent NOL violate the normalization, and what are the**
2 **repercussions from this violation?**

3 A. The IRS has very strict rules requiring utilities to adhere to ARAM when amortizing ADIT.
4 The Company essentially must amortize the specific ADIT by the life of the asset. Each ADIT
5 component has a specific timeframe. All of these components combine to form the whole.
6 The IRS also insists that any NOL be considered in the whole also but NOLs are not
7 amortized. If a company is including a non-existent NOL in its normalization amortizations
8 then that would be an error and thus a violation. An uncorrected violation of the rules would
9 cause the IRS to strip the Company of its privilege to apply accelerated depreciation in the
10 future.

11 **Q. Ms. Hardesty mentioned a Missouri NOL that EMW is including due to the Missouri**
12 **reduction in tax rates from 6% to 4%. Do you object to this calculation also?**

13 A. Yes, but there is a second reason to remove any Missouri specific NOL from the rate base.
14 The Form MO-1120 General Information (Schedule JSR-S-01) indicates that “**Missouri does**
15 **not have provisions for a state net operation loss deduction.**” (Emphasis not added) If
16 Missouri does not recognize a Missouri specific NOL then I don’t believe one should be
17 manufactured for this rate case.

18 **Q. Could you summarize your NOL position?**

19 A. Company and Staff are hanging their hat on a Stipulation and Agreement where the facts no
20 longer align with the premise. The Company has since exhausted its regulatory NOL by
21 applying the balance to several years of taxable income. The NOL balance no longer exists.
22 Company and Staff would lead you to believe that the NOL that was on the regulatory books
23 when the tax rate changed was locked in time and must be amortized in the same way as the
24 deferred tax liability. This is wrong. Ms. Hardesty and I agree that NOLs are not amortized.
25 There is no longer a federal or state NOL to apply to ADIT.

1 **TAX BENEFITS FROM ASSET DISPOSITIONS**

2 **Q. What is your basic argument that these tax benefits should be recognized as a reduction**
3 **to the revenue requirement tax calculations?**

4 A. The Company receives a tax benefit on its federal and state tax return for the early disposition
5 of utility assets that at one time were financed by the ratepayer and those benefits should flow
6 to the ratepayer. Neither Staff nor the Company recognize the benefit in the income tax
7 calculations.

8 **Q. What was the Company's response to your argument?**

9 A. Ms. Hardesty has stated in her testimony:

10 If the tax losses were included as a reduction in current income tax
11 expense without an offset for the impact on deferred income taxes,
12 then the losses would be double counted in computing income tax
13 expense over time.¹⁰

14 **Q. Is this an accurate statement?**

15 A. Yes it is an accurate statement, however, it does not apply here because the deferred taxes are
16 offset so there will not be a double computing of the tax.

17 **Q. How are you sure that there is an offset?**

18 A. The IRS dictates that the corresponding ADIT be removed from the regulatory records.¹¹

¹⁰ Hardesty Rebuttal, page 2, lines 8-10

¹¹ Sections 1.167(a)-8(a), 1.168(i)-8(b)(2) and 1.167(I)-1(h)(2) provide that the accumulated ADIT balance must be adjusted to reflect dispositions. Also, in Private Letter Ruling -101888-23 the IRS stated "the removal of public utility property from the rate base necessitated the removal of the associated ADIT under the Consistency Rule of § 168(i)(9)(B)

1 **Q. To be clear. The Company should have removed the disposed asset, corresponding**
2 **depreciation and the associated ADIT from the regulatory financial records?**

3 A. Yes.

4 **Q. Ms. Hardesty has stated that you have not proposed an offsetting adjustment to the**
5 **deferred tax expense.¹² Is this necessary?**

6 A. No. Ms. Hardesty should be following the normalization rules and removing all of the
7 balances from the records. She has claimed that I've ignored the deferred tax which is as far
8 from the truth as can be. The whole point of recognizing the tax benefits from the disposition
9 is to recapture the remaining ADIT balance and return it to the ratepayer. If the current
10 methodology continues then the ADIT is removed from the books, the Company receives a
11 final tax write-off and the ratepayer gets nothing even though the future tax that created the
12 ADIT and the interest free loan, doesn't exist anymore.

13 **Q. Ms. Hardesty stated that these ADIT balances associated to these tax losses are included**
14 **in rate base.¹³ Is this proper regulatory accounting?**

15 A. No. What Ms. Hardesty is trying to imply is that if you leave the ADIT on the books then the
16 ratepayer still gets the benefit of a reduced rate base and she is implying that the ADIT in
17 question is being left on the books. This defies proper regulatory accounting and
18 IRS/Treasury regulations and inhibits the Company from making a higher net income. The
19 proper accounting and IRS procedure is to remove the asset, depreciation, and corresponding
20 ADIT and then apply the tax benefit to the calculated income tax of the rate case.

¹² Hardesty rebuttal, Page 3 question and answer, line 13-15

¹³ Hardesty rebuttal, page 3 lines 21,22

1 **Q. Ms. Hardesty claims that this tax deduction is a temporary timing difference.¹⁴ Is this**
2 **correct?**

3 A. No. Asset disposition/abandonment is final. All traces of the asset should be removed from
4 the books. This tax deduction does not come full circle unless the benefit is recognized in
5 rates.

6 **Q. If it was allowed, would leaving the ADIT on the regulatory records to continue to**
7 **reduce rate base be an acceptable alternative to the disposition reduction?**

8 A. No. Ms. Hardesty is offering to divvy out breadcrumbs to the ratepayer over a decade or more
9 when the Company gets the last remaining tax benefit immediately without compensating the
10 ratepayer for the remaining ADIT balance that no longer has a future tax liability tied to it.

11 **Q. Has the Commission recognized this asset disposition as a tax deduction in rate cases**
12 **before?**

13 A. Yes. In Case No. EF-2024-0021, the Commission recognized that the abandonment of Rush
14 Island represents a current tax deduction and should offset future income tax liabilities.¹⁵ The
15 concept remains the same here. The disposition (abandonment) is recognized as a tax
16 deduction and should offset current income tax calculations.

17 **Q. Will recognizing this tax benefit in rates result in a normalization violation?**

18 A. No. ADIT calculations stop at retirement. The tax benefits are a post-retirement conclusion
19 to the assets in question.

¹⁴ Hardesty rebuttal first line of page 3

¹⁵ Case No. EF-2024-0021, Amended Report & Order, page 73 - 78

1 **HEDGING LOSSES**

2 **Q Ms. Brooke Mastrogiannis has stated that “Hedging is a safeguard measure to mitigate**
3 **risk.” and “The concept of hedging is to take a small portion of that spot market pricing**
4 **exposure and spread it out to reduce volatility by ‘fixing’ the price via a hedge.”¹⁶ How**
5 **can you respond to those statements?**

6 A. When considering EMW’s natural gas consumption, her statements are purely academic.

7 **Q. Please explain.**

8 A. What Ms. Mastrogiannis states is technically true. Spread the volatility. Provide consistency.
9 This sounds good on paper but that doesn’t mean that there is a place for hedging costs in the
10 Company’s rates. Let’s stop and consider the situation at hand. In the 12 month period of
11 July 2023 through June 2024, EMW spent just over ** _____ ** on natural gas.¹⁷ As
12 Ms. Mastrogiannis points out, the Company had hedging losses of ** _____ ** and of
13 which cross-hedging amounted to ** _____ ** The Company and Staff are requesting
14 that the ratepayers foot the bill for an additional ** ____ ** in natural gas costs. ** _____
15 ** This is unconscionable. At this level, we are no longer discussing “a small portion of that
16 spot market pricing exposure and spread it out ...”.

17 I am disappointed in Staff’s position reversal. I don’t believe Staff understands how truly
18 ineffective EMW’s hedging is in practice. ** ____ ** additional cost is astounding. It is a
19 ridiculous amount of empty expense expected to be backstopped by the ratepayer. But to
20 really pinpoint how egregious the acceptance of this “blank check” by Staff really is, consider

¹⁶ Mastrogiannis rebuttal, page 5, lines 1,8 and 9

¹⁷ Confidential Answer to Staff data request 0041

1 that the Staff fuel run is only including** _____ ** in natural gas costs. The additional
2 expense heaped on the ratepayer is a now ** _____ ** over and above the real expense.

3 **Q. In other words, the costs outweigh the benefits?**

4 A. Yes. Even if you can set aside the magnitude of the losses for a moment, as I stated in direct
5 testimony, EMW does a bad job of hedging. As Ms. Mastrogiannis states in rebuttal, “EMW
6 has explained that hedges will ‘lose’ in downward forward markets and ‘win’ in upward
7 forward markets.” I’ve pointed out in direct testimony that reviewing the monthly hedging
8 reports reveals that this statement isn’t true for this Company. EMW lost money in every
9 month but the highest price month of August. In other words, it lost money in the same
10 months when Ms. Mastrogiannis claims it was supposed to “win.”

11 **Q. Does the Commission have to allow these hedging losses in the revenue requirement?**

12 A. No. As the Company points out and is also spelled out in the Stipulation and Agreement, the
13 hedging results will be recorded in a regulatory account for future rate treatment *determination*
14 in this case.

15 **Q. What do you propose as the disposition of these hedging expenses?**

16 A. As I stated before, the ** _____ ** in cross hedging should be completely excluded
17 from rate consideration of any kind. Given the fact that the entire hedging loss amount
18 represents 35% of the natural gas purchases, this exercise shouldn’t be tolerated and definitely
19 shouldn’t be encouraged. The Company should bear responsibility for all of the hedging
20 transactions; however, I expect that the Commission would seek a compromising position.
21 EMW should absorb ** _____ ** of the fuel hedging costs plus the cross-hedging
22 losses. The ratepayer would have ** _____ ** included in rates over a four-year
23 amortization with no rate base or FAC inclusion. The Commission should order that any

1 future additional hedging transactions should be conducted below the line and be the
2 responsibility of the Company.

3 **Q. Does this conclude your surrebuttal testimony?**

4 A. Yes.

