Exhibit No.:	______________
Issue(s):	Income Tax Expense Lag/ NOL Amount in Rate Base
Witness/Type of Exhibit:	Riley/Surrebuttal
Sponsoring Party:	Public Counsel
Case No.:	GR-2024-0106

SURREBUTTAL 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

September 19, 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 business address?

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

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

A. Yes.

Q. What is the purpose of your surrebuttal?

A. First, I will respond to Company witness Mr. Timothy Lyons' assertion that the income tax expense lag in the cash working capital ("CWC") should be 37 days instead of Staff's 365 days. Then, I will respond to Mr. Michael McCuen concerning a Net Operating Loss ("NOL") balance the company would include in rate base.

Q. Could you please summarize your two positions?

A. My first position is that the expense lag should be 365 days since Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty ("Liberty" or "Company") does not currently pay income tax yet receives the expense in rates. My second position is that the NOL balance proposed by Liberty is overstated due to the Company's failure to follow IRS guidelines on normalization.

INCOME TAX LEAD TIME IN THE CWC CALCULATIONS

Q. What is the reasoning behind Mr. Lyons' contention that the income tax lead in the CWC calculations should be 37 days?

A. Mr. Lyons believes that the expense lag should follow the Internal Revenue Service ("IRS") quarterly payment schedule, which is calculated to be a 37-day lead.

Q. Why has Staff chosen a 365-day lead time?

A. As Staff witness Ms. Lisa Ferguson pointed out in her direct testimony, the Company has not paid income taxes for years, so the lead days should reflect the fact that income tax expense is included in the revenue requirement. However, the Company will not pay taxes to a government agency for an entire year, which would necessitate a 365-day timeframe. This 365-day calculation was established in the Spire rate case that Ms. Ferguson referred to on page 65 of her direct testimony, No. GR-2021-0108.

Q. Why would the adoption of the 37-day IRS schedule be incorrect?

A. CWC is a reflection of the calculated amount of *cash* needed to run the day-to-day operations of the company. Liberty's lack of income tax liability is not in question here. The Company does not pay any taxes but does collect them in rates. The 37-day IRS schedule is specifically established for actual quarterly tax payments. The schedule has nothing to do with Liberty's cash collections or cash payments, since the Company is not responsible for estimated payments.

Q. Please summarize your argument and provide your recommendation.

A. As Staff recognized in its testimony, the Company's lack of income tax pay-outs necessitates its 365-day lag in the CWC income tax calculations. Therefore, I recommend a 365-day expense lag.

RATE BASE EXCLUSION OF THE NOL

Q. In your direct testimony you expressed reservation as to the accuracy of the NOL or deferred tax asset the Company included in rate base. You had hoped the Company would provide some clarity to its included amounts. Has the Company made an effort to solidify its adjustment?

A. No, it has not.

Q. Have you been able to reconstruct the Company's net operating loss carryforward (NOLC) balance?

A. To some degree. I went back to the workpapers and data requests that were included in the Company's previous rate case, No. GR-2018-0013, and cross referenced that information with current information and then tabulated the ongoing NOL balance through 2022. Based on Liberty's annual tax information, the NOL balance associated to accelerated depreciation is $1,022,533, considerably less than Mr. McCuen's recommendation.

Q. Mr. McCuen spoke of the IRS-approved "with or without" methodology and he quoted a Private Letter Ruling ("PLR") No. 201436037. (Schedule-S-01) What is your understanding of the "with or without" method of measuring an NOLC?

A. Another section of this same PLR, Page 2, states:

> Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "with or without" methodology, meaning that an NOLC is attributable to accelerated depreciation to the <u>extent of the lesser of the accelerated depreciation or the NOLC.</u> (Emphasis added)

The NOLC is also referred to as an "ADIT[1] asset". An ADIT asset may include more than just the NOL but the IRS will refer to ADIT assets when it is discussing how the ADIT asset offsets what we commonly refer to as ADIT liability, or just ADIT.

The "with or without" methodology ensures the portion of the NOLC that can be attributed to accelerated depreciation is used to *lower* the balance of the ADIT that Commissions routinely apply to rate base as an interest-free loan. Just as ADIT is calculated by taking the difference between regulatory (straight-line) depreciation and accelerated tax depreciation and multiplying that by the tax rate[2]; the portion of the NOL that is to be considered as a reduction to ADIT is calculated by multiplying the difference between the straight-line depreciation, that is applied to the assets, from the accelerated method used in the tax return multiplied by the tax rate.[3] A brief example would be that Company lost $100,000 on its tax return. The accelerated depreciation on the tax return was $150,000 and the matching regulatory depreciation on the income statement was $100,000. As I pointed out from the PLR, the amount of NOL that must be applied is "the lesser of the accelerated depreciation or the NOLC." The amount of the NOLC directly attributed to accelerated depreciation is $50,000. ($150,000 - $100,000). This is the portion of the NOLC that the IRS indicates should be applied to the ADIT.

[1] Accumulated Deferred Income Tax
[2] (Straight-Line Depreciation – Accelerated Depreciation) x Tax Rate = ADIT
[3] Straight-Line Depreciation= ADIT Reduction

Q. You have made reference to "accelerated depreciation" several times. Are there other deductions that need to be considered in the NOL balance?

A. No. The normalization rules[4] specifically apply to accelerated depreciation, which is depreciation related to plant assets. Repairs and amortization are not considered when assessing normalization adherence. This has also been referred to as "protected" and "unprotected" ADIT. Protected ADIT refers to depreciation that is applied to plant. Unprotected ADIT refers to deductions for basically everything else.

Q. Does Mr. McCuen's testimony indicate that he agrees with your definition of "with or without" methodology?

A. Yes. Page 5 of his direct testimony states:

> The deferred tax asset for the NOL carryforward is presented as a reduction to plant-related deferred tax liabilities because NOLs that would not have resulted had Liberty only deducted the amount of depreciation expense reflected in ratemaking for tax purposes are subject to the deferred tax normalization requirements of the Internal Revenue Code.[5]

The NOL that relates to the difference between accelerated and ratemaking depreciation is the portion of the NOL that falls within the normalization rules.

Mr. McCuen's rebuttal testimony further states:

> That pro-rate approach is concerning in that it distorts the gross deductions by including all of the cost of service deductions in the denominator, thereby artificially reducing the percentage applied to the current year NOL and understating the portion of the NOL attributable

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[4] When the IRS refers to the normalization rules, it is referring to section 168(i)(9) of the IRS code where steps are spelled out to prohibit flow through treatment of accelerated depreciation.

[5] McCuen direct testimony, GR-2024-0106, p. 5, lines 15-19

> to the tax deduction for accelerated depreciation (which is the deduction protected by the IRS normalization rules).[6]

And continues with:

> The pro-rata approach clearly understates the portion of the NOL caused by accelerated tax depreciation.[7]

Q. Now that the "with or without" method has been flushed out, can you walk us through the NOL balances the Company has presented in this case?

A. Starting in 2012, the tax return loss was $6,602,519. The answers to Staff data request 132.1 for this case GR-2024-0106, indicates that regulatory depreciation for the newly acquired Atmos Energy properties was $2,408,802.[8] The tax return provided in data request 132.1 displays an accelerated depreciation balance of $5,594,230. This depreciation balance less the $2.4 million regulatory depreciation mentioned above, would indicate that $3,185,428 of the $6,602,519 NOL was attributed to accelerated depreciation.

In 2013, the Company indicated that it lost $6,067,805, however, accelerated depreciation exceeded straight-line depreciation by over $12 million. A quick look back at the IRS quote from the PLR above tells us that the amount to include should be the "lesser of the accelerated depreciation or the NOLC", which would indicate that the $6,067,805 is the amount of the NOLC for the following year.

In 2014, the tax return loss was $17,405,590. A further review of the expenses reveals that the loss was more due to a purchase gas adjustment ("PGA") in the cost of goods sold than by

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[6] McCuen rebuttal testimony,GR-2024-0106, p. 3, lines 9-14.
[7] Id. at lines 21 and 22
[8] All related workpapers that substantiate my yearly calculations will be included in (JSR-S-01)

accelerated depreciation. However, recognition of the $9,939,063 difference in straight-line and tax depreciation must be taken into account when measuring the NOLC.

In 2015, the tax loss of $3,538,008 on Liberty's return does not exceed the accelerated depreciation balance of $8,967,404 so the entire $3,538,008 amount is considered an NOLC.

In 2016, the proforma tax return indicates that Liberty lost $10,585,814. However, $8,985,632 was attributed to accelerated depreciation.

Determining the amount of accelerated depreciation that was attributed to the NOL of $10,209,950 in 2017 was a bit more complicated. The Company did not include a separate depreciation line item on the 2017 federal tax return, Form 8916, so I inserted a 2017 KPMG workpaper amount from data request 0129 from the 2018 case. The accelerated depreciation included on the tax return was reduced by the $10,114,281 straight-line depreciation from the workpaper to provide a $6,229,176 amount of NOLC attributed to the accelerated depreciation.

Q. In 2018, 2019 and 2020 the Company had positive taxable income. How did you incorporate these results in your NOLC total?

A. I applied the NOLC to the positive taxable income in each of the years to reduce the balance going forward. The taxable income was $15,460,583 in 2018, $8,488,330 in 2019 and $6,339,218 in 2020.

Q. The Company had taxable losses again in 2021 and 2022. Did you include any amount of these totals in your ongoing NOLC balance?

A. No. Interestingly enough, the amount of accelerated depreciation in each of these years was less than the straight-line depreciation. The 2021 M-1 information tab in the answer to Staff data request 0132, from the current case, indicates that book depreciation was $12,339,237 and the tax depreciation was $10,206,603. For 2022, the book depreciation was $12,475,818 and the tax depreciation was $11,685,136. In both cases none of the NOL could be attributed to accelerated depreciation, so none of those tax losses were included in the ongoing NOLC balance.

Q. What amount of NOLC did you calculate from your recognition of accelerated depreciation in the taxable losses?

A. I used a spreadsheet, included below, that the Company provided in its answer to Staff data request 0132. I then placed side-by-side columns for the Company's listed NOL and my accelerated depreciation related NOL. The balance from my adjustments provides a total cumulative NOL of $6,869,203 with a federal tax-effected balance of $1,022,533.

Liberty Utilities (Midstates) - Missouri

Net Operating Loss

	Liberty Utilities (Midstates Natural Gas) Corp.			Jurisdictional
	Taxble Income (Loss)	Taxble Income/ (Loss) RELATED TO ACCELERATED DEPR.	Cumulative	69.812%
5/10/2011				
12/31/2012	(6,602,519)	(3,185,428)	(3,185,428)	(2,223,811)
12/31/2013	(6,067,805)	(6,067,805)	(9,253,233)	(6,459,867)
12/31/2014	(17,405,590)	(9,939,063)	(19,192,296)	(13,398,526)
12/31/2015	(3,538,008)	(3,538,008)	(22,730,304)	(15,868,480)
12/31/2016	(10,585,814)	(8,967,404)	(31,697,708)	(22,128,804)
12/31/2017	(10,209,950)	(6,229,176)	(37,926,884)	(26,477,516)
WhitePaper	664,017	664,017	(37,262,867)	(26,013,953)
12/31/2018	15,460,583	15,460,583	(21,802,284)	(15,220,611)
12/31/2019	8,488,330	8,488,330	(13,313,954)	(9,294,738)
12/31/2020	6,339,218	6,339,218	(6,974,736)	(4,869,203)
12/31/2021	(10,576,818)	-	(6,974,736)	(4,869,203)
12/31/2022	(2,910,623)	-	(6,974,736)	(4,869,203)
	(36,944,979)	(6,974,736)		(4,869,203)
				Tax effected
		$ 4,869,203	21%	$ 1,022,533

Q. Liberty included the entire NOL for each year in its calculation. Why do you believe the Company applied the entire amount of the NOL balance?

A. The Company's method came from how it defines "accelerated depreciation." judging from its answer to Staff data request 0132.1 below:

The following is the Net Operating Loss for Liberty Utilities (Midstates Natural Gas) Corp. To get to the Missouri allocation multiply by the MO jurisdictional percentage. As shown, the loss was generated from accelerated depreciation.

Attached are copies of the Federal Tax Returns for each year.

Tax Year	Federal 1120 Ln. 30	Federal 1120 Form 4562, Ln. 22
2012	(6,602,519)	(5,594,230)
2013	(6,067,805)	(18,708,181)
2014	(17,405,590)	(18,653,724)
2015	(3,538,008)	(17,585,880)
2016	(10,585,814)	(18,412,714)
2017	(10,209,950)	(16,343,457)

Liberty views all the depreciation included on a tax form as accelerated. Therefore, any NOL balance less than that amount must be generated from that total depreciation. The Company logic then would be to apply the entire NOL balance against ADIT. I don't believe that the total depreciation is the "accelerated depreciation" the IRS mentions in the PLRs.

Q. How do you believe the IRS defines accelerated depreciation?

A. The accelerated depreciation that the IRS measures against NOL balances is the difference between the regulatory (book) depreciation used in rates and the accelerated depreciation applied to tax returns. The IRS's methodology is based exclusively on the difference between book and tax depreciation multiplied by the tax rate. Any deviation from this methodology would be a violation of the consistency rule of normalization. We must calculate ADIT and the NOL balance that is applied to ADIT using apples and apples or the outcome would be punitive.

Q. Please explain this inconsistency.

A. ADIT that ratepayers provide as an interest-free loan is calculated by subtracting book depreciation from the accelerated depreciation and applying the tax rate to that balance, i.e. $200 accelerated depreciation - $100 book depreciation = $100. That $100 is multiplied by 21% to produce $21 of ADIT. When determining "that portion of the NOL attributable to accelerated depreciation" the amount of accelerated depreciation is *not* the $200 in the example but <u>the $100 difference</u> between book and tax depreciation. Therefore, the book depreciation of $100 would be included in the tax return if the accelerated depreciation of $200 wasn't available. In this abbreviated example, if the $200 was established as the reduction amount of the NOL against ADIT, then the ADIT would go negative ($200 x 21% = $42). The ADIT was created using the difference in depreciation methods, so the NOL offset to the ADIT balance has to be the same.

Q. What is the amount of Missouri specific NOL that should be included in the rate base?

A. Instructions for MO-1120 corporate tax return indicate that the Department of Revenue does not recognize state specific NOLC, so there was no calculations on the state level. (Schedule-S-03)

Q. Could you please summarize your position on the NOL amount in rate base?

A. Company has incorrectly included all of the cumulative amount of NOL in its calculation to offset the ADIT liability. Only the portion of the NOL that is attributed to accelerated depreciation should be included. Recalculating the NOL for only the difference between book and tax depreciation reduces the amount of the ADIT asset to a tax effected balance of $1,022,533. This amount should be the reduction to ADIT in the rate base calculations.

Q. Does this conclude your surrebuttal 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 surrebuttal 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 September 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.