

Exhibit No.: _____
Issue(s): Adjusting Income Tax Calculations/
Cash Working Capital Adjustments/
Rate Case Expense/NOL in Rate Base/
Pre-Tax Rate of Return in WSIRA/
Tax Gross-up in Revenue Requirement
Witness/Type of Exhibit: Riley/Direct Rebuttal
Sponsoring Party: Public Counsel
Case No.: WR-2024-0320

DIRECT/REBUTTAL TESTIMONY

OF

JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

FILE NO. WR-2024-0320

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

The information that is redacted in Public Counsel witness John Riley's direct testimony is redacted because another party has identified that information to be confidential in response to a discovery request. Rule 20 CSR 4240-2.135(5)(A).

December 6, 2024

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TABLE OF CONTENTS

Testimony	Page
Adjustments to Net Income Tax Calculations	2
Cash Working Capital (“CWC”) Adjustments	4
Eliminate NOL from Excess Deferred Tax Calculations	8
Reduce the Pre-Tax Rate of Return in WSIRA	12
Tax Gross Up on the Revenue Requirement	14

**DIRECT TESTIMONY
OF
JOHN S RILEY
CASE NO. WR-2024-0320
MISSOURI AMERICAN WATER CO.**

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

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

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

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

6 **Q. What is your educational background?**

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

9 **Q. What is your professional work experience?**

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

18 **Q. Are you a Certified Public Accountant (“CPA”) licensed in the State of Missouri?**

19 A. Yes. As a CPA, I am required to continue my professional training by attending Missouri
20 State Board of Accountancy qualified educational seminars and classes. The State Board of

1 Accountancy requires that I spend a minimum of 40 hours a year in training that continues
2 my education in the field of accountancy.

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

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

5 **Q. What is the purpose of your direct testimony?**

6 A. The purpose of this direct testimony is to adjust Missouri American Water Company's
7 ("MAWC") income tax and rate case expense. I will also reduce the cash working capital
8 balance ("CWC") as well as adjust rate base for the net operating loss carryforward ("NOLC"
9 or "NOL"). I will also argue that a pre-tax rate of return is unnecessary when calculating
10 WISRA revenues. Finally, I argue to eliminate the gross-up tax calculations that Staff
11 performs to finalize the revenue requirement on Schedule 1 of the Accounting Schedules. All
12 of these adjustments are due to the fact that MAWC does not owe a tax liability as a stand-
13 alone company.

14 **ADJUSTMENTS TO NET INCOME TAX CALCULATIONS**

15 **Q. What are you proposing to adjust in the income tax calculations?**

16 A. The Company has failed to recognize MAWC specific impairments, retirements or
17 gain/losses that have been recorded on the federal tax returns of American Water Works.
18 These tax reductions should be recognized when performing the income tax calculations in
19 the Staff accounting schedules.

20 **Q. Could you provide some context to these impairments, retirements or gain/losses from
21 sales of utility property?**

22 A. Sooner or later, assets used in the course of providing utility service, will wear out, break
23 down or be supplanted by better technology. These assets can be traded in, sold or merely

1 discarded or retired. Often, this disposition is before the expected useful life is completed.
2 Generally, any retirement or disposal prior to the asset being completely depreciated for tax
3 purposes, will generate some sort of loss on the income tax return. Any loss recognition would
4 be a deduction to taxable income.

5 **Q. What would be the basis for recognizing these reductions?**

6 A. These assets that have created these losses were funded by the ratepayer. The assets provided
7 a rate of return to the Company as well as generated taxes, deferred and current that will never
8 be paid to a taxing authority due to early removal. This was all funded by the ratepayer. It is
9 only just and reasonable that the ratepayer receive a benefit from the tax deduction that occurs
10 when the asset, that the ratepayer has funded, is retired prematurely. Ignoring the tax benefit
11 allows the Company an unrecognized chunk of income and essentially increases the
12 Company's rate of return beyond what the Commission authorized by way of excess income
13 tax expense and unreturned deferred taxes. The ratepayer is due a refund.

14 **Q. How does Staff normally calculate income tax for a general rate case?**

15 A. Staff has a standard set of line items that is added to or deducted from a starting taxable income
16 number. Additions are made to reclaim some nondeductible expenses and the straight-line
17 depreciation. This total is the Additions to net income.

18 Next, Tax depreciation, interest on debt, nuclear decommissioning and preferred dividends
19 are subtracted. This allows an offset between ratemaking depreciation and accelerated
20 depreciation for tax purposes. This keeps the income tax calculations in-line with the IRS
21 normalization rules that basically state that for income tax expense in rates, straight line
22 depreciation is used, and for income tax on the consolidated tax returns, accelerated
23 depreciation is applied.

1 **Q. This is the point in the tax calculations where you believe the retirement, abandonment**
2 **or general dispositions should be considered as a decrease to taxable income?**

3 A. Yes. This loss deduction, which is usually found on Form 4797, should be treated as a
4 reduction to taxable income as it was on the consolidated tax return. This will lower the
5 income tax expense applied to the test year and ultimately the entire revenue requirement
6 calculation.

7 **Q. How would you propose to calculate this adjustment?**

8 A. By reviewing the Company workpapers and the yearly consolidated federal tax return, an
9 annual amount can be calculated. The 2023 and 2022 tax returns indicate that Form 4797 had
10 a loss of **_____, ** respectively. The average could be applied as an
11 annual, normalized level and reduce taxable income, when computing income tax for rates,
12 by **_____ **

13 **CASH WORKING CAPITAL (“CWC”) ADJUSTMENTS**

14 **Q. Could you provide a brief explanation of the components of a CWC calculation?**

15 A. Yes. Borrowing from a standard Staff definition as follows:

16 Cash Working Capital (CWC) is a rate base component that represents
17 a measurement of the amount of funds, on average, required for the
18 payment of a utility’s day-to-day expenses, as well as an identification
19 of whether a utility’s customers or its shareholders are responsible for
20 providing these funds in the aggregate.

21 In a CWC calculation, both a revenue lag and an expense lead/lag are measured. The “lag” is
22 the amount of time, measured in days, that it takes revenues to come in from the customer or
23 the time it takes for the utility to pay out an expense. MAWC has calculated a 48.7 day lag
24 for revenues to come in from their customers. Customer payments are standardized so the

1 revenue lag is a consistent multiplier in the calculation. In contrast, each expense component
2 of the CWC calculation has a different payment schedule based on when the individual
3 expense needs to be paid. As a result, the expense lag is different for each line item.

4 **Q. What is your first adjustment to this rate base item?**

5 A. The income tax expense lag should be adjusted to reflect the collection of, yet nonpayment of
6 income tax for the entire 365 day year.

7 **Q. What is the lag time that the Company is using for the income tax calculations?**

8 A. Company is using a standard IRS quarterly tax payment lag of 35.6 days. This would be the
9 normal timeframe if the Company actual is required to pay quarterly taxes, however, MAWC
10 is not currently required to submit quarterly payments.

11 **Q. What expense lag are you proposing for federal and state income taxes?**

12 A. The income tax expense lag should be 365 days. MAWC is not in a position where it is liable
13 for federal or state income tax. Income tax expense is collected but not paid out to a taxing
14 authority. The Commission has ruled that an expense lag of 365 days represents the
15 nonpayment of these taxes collected through rates yet not paid out.¹

16 **Q. What other adjustments to the CWC calculations are you proposing?**

17 A. Mr. Walker III, who also performed the CWC calculations in the 2022 case, has made an
18 interesting adjustment to his 2024 report. The revenue lag has been extended three additional
19 days and the overall revenue lag is now 48.7 as opposed to 45.7 in the 2022 case. This lag
20 time should revert to the previous 45.7 day time frame.

¹ Spire Missouri, CASE NO. GR 2021-0108, Amended R&O pages 27-31.

1 **Q. What is the main cause for this three day difference?**

2 A. The billing lag, which is the time to prepare and mail out the bills after the meter has been
3 read, was established to be 2 days in the 2022 rate case but has been extended to 5 days for
4 this study. This delay is the root cause of the three day increase in the overall revenue lag.

5 **Q. What could be the cause of this additional lag time?**

6 A. It is hard to say. One would expect that the meter reading/billing time would be as efficient
7 as the 2022 study given the fact that MAWC touts the remote reading (“AMI”) meters as a
8 leap forward in efficiency. With AMI meters, one could expect a speedier process. The usage
9 information can be downloaded at night and be ready for dissemination to the customer by
10 way of bill generation the next day. This additional 3 day delay would seem to be solely
11 Company generated.

12 **Q. What would the reset of the revenue lag back to 45.7 days do to the CWC balance?**

13 A. The overall CWC balance adjusts from a Company generated negative \$2,015,024 in rate base
14 to a negative \$4,223,270. An additional \$2,208,246 reduction to rate base.

15 **Q. What would the OPC adjustment be with the previous 45.7 revenue lag and the 365 day
16 income tax expense?**

17 A. The CWC balance to include in the rate base calculations should be a negative \$21,567,773.²
18 The difference to the Company’s CWC balance is (\$19,552,749). I should point out here that
19 the income tax balance is a fluid number that will change until the final tabulation and
20 calculation of the revenue requirement. Any CWC income tax adjustment will be a close
21 approximation until the final calculations.

² Fed income tax = (\$15,176,965), State = (\$2,672,452) with a 365 expense and a 45.7 revenue lag.

1 **Q. Do you have any other revenue requirement adjustments that are related to CWC**
2 **calculations?**

3 A. Yes. I will be making an adjustment to rate case expense for the cost of the CWC study and
4 the consulting fee from Mr. Walker. This outside generated study wasn't necessary.

5 **Q. What would be the amount of the rate case expense adjustment?**

6 A. The cost of the CWC study and Mr. Walker's consulting fee have not been provided yet due
7 to the Company's failure to provide answers to my data request, in a timely manner. I will
8 file supplemental testimony or include the actual adjustment in the next round of testimony
9 when I have a reasonable idea of the cost involved.

10 **Q. Why this particular disallowance in this case?**

11 A. There was no Company testimony filed for CWC in either the 2015 or the 2017 case so my
12 assumption is that the CWC was compiled in-house. A study was commissioned for the 2022
13 rate case, which pans out to at least seven years without a commissioned study. It may very
14 well have been overdue by 2022 but why commission another CWC study for a case two
15 years later? Creating a whole new study was unnecessary. The Company could just as easily
16 put together a new CWC calculation, inhouse, by updating the balances. The revenue lag in
17 the 2017 case was 45.60³ which compares very favorably with the commissioned study in
18 2022 and would be spot on with the revenue lag in this case if the Company stuck to the more
19 efficient billing lag of 2 days. Payment and collections methods should be getting more
20 efficient, not less. If anything, one would expect a faster revenue lag due to credit card
21 payments and electronic bill pay. I have not been able to find where the Commission ordered

³ The calculated revenue lag was 46.44 but when the "lockbox float" is eliminated then the lag is very similar to 2022 of 45.7.

1 a new study and I don't see rapidly changing financial conditions to justify a study two years
2 later.⁴

3 **Q. Could you summarize the CWC issues?**

4 A. First, the income tax lag: It was established by the Commission several years ago that an
5 absence of an income tax liability necessitates a 365 expense lag. Second, reset the billing
6 lag. There is no justification in testimony for the change in billing lag which is the root cause
7 of the 3 day increase in the overall revenue lag from 2022 to now. Finally, rate case expense
8 should be reduced by the cost of the CWC study and Mr. Walker's fee. This new study was
9 unnecessary as the Company could very well have updated the 2022 balances and been as
10 confident in the rate base as was apparently done in 2015 and 2017.

11 **ELIMINATE NOL FROM EXCESS DEFERRED TAX CALCULATIONS**

12 **Q. Please explain the characteristics of a net operation loss ("NOL").**

13 A. An NOL is a tax return item produced by taxable expenses exceeding taxable revenues,
14 producing a loss on the tax return. For example: if XYZ, Inc. has taxable revenues of \$1
15 million and taxable expenses of \$2 million, then XYZ, Inc. has a NOL of \$1 million to be
16 carried forward to the next tax return (\$1 million taxable revenue - \$2 million in taxable
17 expense = \$1 million NOL). Losses accumulate so long as there is no taxable income to
18 offset. If XYZ, Inc. loses \$1 million in 2022, suffers a \$2 million loss in 2023, and has taxable
19 income in 2024 of \$2 million, then, after the 2024 return is filed, XYZ, Inc. will have an NOL
20 balance of \$1 million. (\$3 million balance less \$2 million applied to the income.) The \$1
21 million will continue to be carried forward until the Company has taxable income again to
22 apply the NOL balance as an offset and is thus referred to as a net operating loss carryforward
23 ("NOLC"). Companies argue that any NOLC balance should be an offset to the accumulated

⁴ Case No. WR-2017-0285, direct testimony of Company witness Brian LaGrand stated that a lead/lag method to calculate its working capital requirements has been utilized by the Company for the last several cases. Page 25

1 deferred income tax ("ADIT") balances that are included as a reduction to the rate base
2 balance of a company. If included in this manner, the NOLCs reduce ADIT, thereby
3 increasing rate base.

4 **Q. Has MAWC included an NOLC in its rate base balance?**

5 A. Initially, the Company indicated in the answer to OPC data request 1301 that there were no
6 NOL balances included, however, in the response to 1306 it was outlined what was included
7 in the excess deferred income tax balance (EADIT). Federal and State NOL balances which
8 were incurred prior to the enactment of the Tax Cut and Jobs Act (TCJA) were included.

9 **Q. Please explain how EADIT came to be.**

10 A. The federal government spurs investment by providing tax incentives to companies so they
11 will invest and provide economic development. Allowing a company to accelerate the
12 depreciation of an asset creates a reduced tax liability situation putting more money in the
13 company coffers to spend on assets. ADIT, which is Accumulated Deferred Income Tax is
14 the collection of tax subsidies created by the difference between straight-line depreciation and
15 tax return accelerated depreciation. This balance represents a liability because accumulated
16 tax deferrals will eventually swing full circle and be paid back to the ratepayer. Before that
17 happens, though, the increase in income tax expenses used on a tax return (as compared to
18 what was included for ratemaking purposes) provides an interest free loan to the utility in the
19 form of a temporary tax break. Example: Straight-line depreciation for ratemaking is \$100.
20 For tax purposes the company can apply \$200. This \$100 difference represents a deferred
21 income tax of \$21 after applying the 21% corporate tax rate ($\$100 \times 21\% = \21). How is this
22 \$21 funded? The ratepayer pays taxes as if there is no accelerated depreciation which allows
23 the company to claim the \$21 windfall. This balance accumulates so long as the accelerated
24 depreciation is greater than the straight-line. So, for this example, five years of accelerated
25 depreciation would be \$105 in ADIT. The tax benefits are applied in the early years while

1 tax payback happens many years down the road meaning that the ratepayers have effectively
2 loaned the company \$105 without interest by the grace of the federal government.

3 If the tax rate is reduced while there is an ongoing ADIT balance, then the new reduced rate
4 essentially puts some tax liabilities in limbo. The effected ADIT balance is referred to as
5 excess accumulated deferred income tax (“EADIT”). For almost all companies currently in
6 operation, any EADIT on their books was generated by the 2017 TCJA which changed the
7 tax rates from the 38% to 21%. Deferred taxes collected at 38% will now be paid back at 21%.
8 Returning to the example, above, the amount of the EADIT can be calculated by subtracting
9 the ADIT at the lower tax rate from the ADIT that would have been generated at the higher
10 tax rate. $\$100 \times 38\% = \38 , $\$100 \times 21\% = \21 . A \$17 difference which won’t be returned to
11 the ratepayers if the Commission doesn’t recognize the lost difference. The Commission set
12 up an Excess Deferred Income Tax balance. The orphaned \$17 was placed in the EADIT
13 balance. In our example, there is still \$38 of deferred tax, however, it is now split between
14 the new ongoing ADIT balance of \$21 and the \$17 EADIT. Both balances are amortized so
15 the ratepayer who financed the deferred taxes will eventually receive its funding returned.

16 **Q. What are the similarities and differences between an NOL and ADIT?**

17 A. The IRS maintains that ADIT or EADIT created by accelerated depreciation must be
18 amortized over the life of the asset. Therefore, if a 50-year asset created \$1,000 in ADIT, that
19 \$1,000 would be amortized over 50 years and thus would cause an amortization of \$20 a year
20 ($\$1,000/50 \text{ years} = \20 per year). ADIT is asset specific and is driven by accelerated
21 depreciation where as an NOL is tax return driven by way of adding all taxable revenues and
22 offsetting them with all taxable expenses. Often, an NOL is created by the combination of
23 tax breaks, accelerated depreciation being the most prevalent.

24 The IRS demands that ADIT be amortized over the life of the asset so that the tax break does
25 not immediately get returned by flowing the break right back through rates. ADIT represents
26 the tax adjusted balance of accelerated depreciation. The \$100 from my example is tax

1 adjusted to \$21 and that is the adjustment to rate base. An NOL is a dollar amount difference
2 between taxable revenue and expenses. It does not get amortized, and, for tax return
3 application, it does not get tax adjusted. Back to our examples, \$100 in taxable income less
4 \$200 in expense creates a \$100 tax loss. If you find the section of MAWC's consolidated tax
5 return that tracks the ongoing total operating losses, you will find it to be an unadjusted \$100
6 not \$21. The reason the NOLC are displayed as unadjusted is because the creation of or the
7 application of an NOL is not affected by income tax rates. Further, as already explained NOLs
8 are carried forward and do not get amortized. NOLs accumulate until the company has a tax
9 return that produced taxable income and then a portion of the NOL is applied to the taxable
10 income. For ratemaking purposes, an NOL is considered a deferred tax asset because it can
11 be applied to a possible tax liability and offset it.

12 **Q. Are you taking issue with the Company including an NOLC in the EADIT balance**
13 **adjusting rate base?**

14 A. Yes. The way the Company has calculated its EADIT in a way that suspended the use of the
15 NOL and amortized it within the EADIT balance. I contend that the NOL in question no
16 longer exists and the EADIT balance should be uninhibited by a fictitious deferred tax asset.

17 **Q. What is the amount of the adjustment?**

18 A. I have attached the Company EADIT workpaper as Schedule D-02. The NOL balances that
19 have been amortized from Jan. 2018 to the end of 2024 amount to \$21,371,624. The EADIT
20 balance should be adjusted by the \$21 million to correct the inclusion.

21 **Q. You had mentioned that the NOL consumption was suspended. Could you please**
22 **explain?**

23 A. As I pointed out previously, an NOL is not amortized, it sits until needed. If the company is
24 in a profitable situation, there isn't a choice as to foregoing the use of the NOL. It is applied
25 to the net income. My point here is that American Water Works had an overall consolidated

1 net income in at least 2017 through 2021. This is the same timeframe as the creation of the
2 EADIT with NOLCs included. Due to a corporate Tax Allocation Agreement (“TAA”), those
3 profits would have consumed the corporation’s overall NOL balances. MAWC has stated
4 that it did not intend to include an NOL balance in rate base⁵, however, it chose to include
5 NOL balances in the EADIT and amortize it like the deferred liability. This is an incorrect
6 methodology for two reasons. The first is that NOLs are not amortized and secondly, the
7 profits of 2017 through 2021 would have reduced these possible NOL balances to zero.

8 **Q. Could you summarize your position concerning NOL balances within the EADIT rate**
9 **base component?**

10 A. If the Company didn’t intend to include an NOLC in rate base, why try to slide questionable
11 balances in the EADIT? It appears that the consolidated corporation allocated all of its
12 available NOL balances during the 2017-2021 timeframe so the NOLC included in the
13 EADIT balances doesn’t exist. The rate base should be decreased by \$21,371,624.

14 **REDUCE THE PRE-TAX RATE OF RETURN IN WSIRA**

15 **Q. Could you provide an overview of the WSIRA process?**

16 A. The water and sewer infrastructure rate adjustment (“WSIRA”) is an interim rate adjustment
17 that allows costs related to the replacement of water pipe (infrastructure) to be summarized
18 and added to the company’s rate base. A rate of return is calculated on the additional rate
19 base and included in the WSIRA revenue requirement. These proceedings and revenue
20 requirement additions are conducted in between general rate cases.

⁵ MAWC’s answer to data request 1301S

1 **Q. What is the adjustment you are proposing?**

2 A. My proposal is for the Commission to calculate WSIRA revenues using only the standard rate
3 of return that is established in the general rate case and not using a “pre-tax rate of return.”

4 **Q. Does the Commission normally apply what is referred to as a “pre-tax rate of return?”**

5 A. Yes, in some form or another. That is the established rate of return with a calculated tax
6 amount built into the percentage. If the rate of return for the general rate case is 7.74%, then
7 dividing the rate by an inverse of the applicable corporate tax rate (1-tax rate (23.84%)) would
8 make the pre-tax rate of return 10.16%. In WSIRA cases, the Commission applies this
9 adjusted rate to the rate base or else Staff calculates the taxes using the composite tax rate.
10 The Commission applies tax because the statute states that “Appropriate pretax revenues”
11 should consider income taxes, depreciation and property taxes in order to produce net
12 operating income. What the Commission has overlooked, however, is the fact that MAWC
13 does not have a tax liability. Therefore, it is not necessary to calculate a tax on the interim
14 revenues generated by the WSIRA simply because there are no “taxes applicable” to the
15 revenues. To put the matter simply, because the Company pays no taxes, the appropriate
16 pretax revenue required by the statute does not need to include any taxes so there is no reason
17 to utilize a “pre-tax” rate of return (which is just a way of including taxes in the rate of return).

18 **Q. If taxes are not included in the interim WSIRA cases, when would they be calculated?**

19 A. The proper tax calculations will be performed on the combined revenues in the next general
20 rate case. In order to produce the proper net operating income, depreciation and property
21 taxes are the only expenses that should be addressed prior to the next general rate case.

22 **Q. What is the effect of the Commission including income taxes in the WSIRA calculations?**

23 A. Essentially, the Company is afforded a rate of return over and above the established rate from
24 the last rate case. Look at it this way. If the Commission applies tax to the WSIRA revenues

1 with no tax due, then the tax is now nothing more than additional revenues (profit). The
2 operating income is actually more than the Commission allowed because the tax expense
3 becomes additional income.

4 **Q. How is that different than income tax calculated and included in revenue requirement**
5 **of a general rate case knowing that the Company will never pay the taxes to the**
6 **government?**

7 A. First off, per the IRS code, income taxes have to be calculated and applied in a general rate
8 case to prevent the dreaded normalization violation. That is the IRS determination. Why is
9 it different for an interim rate case? The whole point of a WSIRA is to defeat regulatory lag.
10 That objective has been accomplished. But there is no lag on income taxes in the interim
11 because there aren't any due. The revenues that were developed in the WSIRA don't have an
12 income tax liability that has to be calculated in the interim. The WSIRA revenues will be
13 included and taxed in the next general rate case.

14 **Q. Could you summarize your WSIRA income tax argument?**

15 A. The Commission should not add income tax expense to the WSIRA revenue calculations due
16 to the absence of a current tax liability. Including additional revenues to cover nonexistent
17 taxes amounts to an increase over the stated rate of return. The taxes that must be calculated
18 and collected on these revenues will be managed in the next general rate case.

19 **TAX GROSS UP ON THE REVENUE REQUIREMENT**

20 **Q. What adjustment to the overall revenue requirement are you proposing?**

21 A. Due to the Company's NOL position, the Company is not in a situation where additional
22 income taxes need to be calculated to sustain the Commission's established return on equity.
23 In simple terms, the tax gross up does not need to be applied to the income tax calculations
24 when determining the revenue requirement that should be ordered by the Commission.

1 **Q. Please explain what a tax gross-up is and how it applies in a rate case.**

2 A. A tax gross-up is an additional amount of money added to a utility's revenue requirement to
3 cover the income taxes that the utility will owe on its revenue requirement. In a rate case, the
4 Commission sets the revenue requirement for the utility. This is essentially done by
5 multiplying the utility's rate base by the ordered rate of return ("ROR") and then adding in
6 non-capital expenses and taxes. The Commission's staff then calculates what the Company
7 is currently making with its existing rates and determines how much additional net income is
8 required to raise the Company's income to the established Rate Base/ROR level. This
9 additional income is generally referred to as the "revenue requirement." To illustrate, let's
10 use an example of a \$250,000 operating income requirement and a Commission staff
11 accounting schedule that calculates the current utility income at \$150,000. This would point
12 to a \$100,000 shortfall, so the Schedule lists a \$100,000 in additional net income is needed to
13 reach the total net operating income requirement. It's important to understand that the
14 Commission has established this income to be the Company's total cost of operations
15 (including profit), and that amount would be net of taxes. That means that taxes have already
16 been included in this amount. However, per the IRS, income taxes must also be applied to
17 the additional \$100,000 revenue requirement because the \$100,000 additional income is, in
18 itself, additional taxable revenues. Therefore, it becomes necessary to determine how much
19 more income is necessary to cover the taxes owed on the additional income that the Company
20 will need to continue its operations (including pay the additional taxes). This additional
21 income included to cover the taxes owed on the increased revenue the Company needs (which
22 includes the amounts needed to pay taxes) is the tax gross-up. Stated simply, it is the tax
23 calculated on a tax.

24 The established composite tax rate (federal and state tax rates combined) is 23.84%. To
25 calculate the tax on tax, a nifty formula was created to produce a single multiplying factor to
26 determine how much income tax should be included in the cost of service.

1 The current gross-up factor is 1.313. $1/(1 - \text{tax rate})$

2
3 $1/(1 - 0.2384)$
4 $1/(.761598715)$
5 $= 1.313027425$
6

7 So, the calculated tax on a given addition to the revenue requirement would be \$100,000 X
8 1.313 = \$131,302.74 or an additional tax of \$31,302.74. The straight tax calculation is
9 \$100,000 multiplied by the composite tax rate of 23.84% to produce \$23,840 in tax.

10 **Q. What changes are you proposing to the calculations you demonstrated earlier?**

11 A. Because MAWC's tax obligation is zero, the tax calculation should be just a simple composite
12 tax of 23.84%, not a 1.313 gross-up.

13 **Q. Are these tax calculations required by the IRS?**

14 A. No. The IRS does require that the tax calculations for a utility rate case must avoid using
15 accelerated depreciation in order to avoid the dreaded normalization rule violations.
16 However, the Staff accounting schedules already apply straight-line depreciation to the
17 income tax schedule, so accelerated depreciation is not used. There is no additional
18 requirement that the Commission ignore the reality that the accelerated depreciation has put
19 the Company in a net operating loss position when calculating what, if any, amount of tax
20 gross-up is required.

21 **Q. Are you proposing that Staff apply 23.84% to the "additional Net Income Required"**
22 **instead of the 1.313 that is built into the calculation?**

23 A. For MAWC, who is in an NOL situation and isn't required to pay taxes, I am. Referring back
24 to my \$100,000 example, the point of a gross-up is to make the Company whole in regard to

1 the \$100,000 addition.⁶ The IRS required tax to be collected on the \$100,000 additional
2 income but the Company doesn't owe any additional tax (tax on tax) to make its \$100,000
3 income addition whole. Therefore, no tax gross-up needs to be performed.

4 **Q. Please summarize this issue.**

5 A. The whole point of a tax gross-up is to satisfy the cost of the tax on tax that is created by the
6 original income tax calculation. A Company that is not in a taxable situation does not need a
7 gross-up to make its required ROR whole.

8 **Q. Does this conclude your direct testimony?**

9 A. Yes.

⁶ The Commission grants the Company an additional \$100,000 profit, not \$100,000 less the taxes. To keep the \$100,000 intact, the taxes will need to be collected from the ratepayer.

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

In the Matter of Missouri-American Water)
Company's Request for Authority to Implement)
a General Rate Increase for Water and Sewer)
Service Provided in Missouri Service Areas) Case No. WR-2024-0320

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/rebuttal 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.

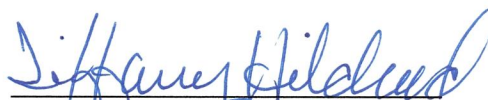


John S. Riley
Utility Regulatory Supervisor

Subscribed and sworn to me this 5th day of December 2024.

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

My Commission expires August 8, 2027.



Tiffany Hildebrand
Notary Public