

Exhibit No. 209

Exhibit No.: _____
Issue(s): Purcell Regulatory Asset and
Amortization/Income Tax Expense Reduction/
WSIRA Pre-Tax Rate of Return
Witness/Type of Exhibit: Riley/Rebuttal
Sponsoring Party: Public Counsel
Case No.: WR-2022-0303

REBUTTAL TESTIMONY

OF

JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2022-0303

January 18, 2023

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REBUTTAL TESTIMONY

OF

JOHN S. RILEY

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2022-0303

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 rebuttal?**

7 A. I will address three things:

8 1) Staff has included an amortization for an unpaid business expense created by agreement
9 between the City of Purcell and MAWC. I will point out that the rest of MAWC's customers
10 should not be responsible for the financial difficulties between the City of Purcell and
11 MAWC.

12 2) Staff has included in its Revenue Requirement, Accounting Schedule: 1 - \$8,829,638 for
13 additional income tax requirements. I will argue that MAWC should not be allowed
14 additional income taxes in these proposed rates.

15 3) I will also recommend that the Commission recognize that since MAWC does not produce
16 an annual income tax liability, establishing a pre-tax rate of return for water and sewer

1 infrastructure rate adjustment (“WSIRA”) calculations is overstating allowable revenue
2 requirement in the interim cases.

3 **CITY OF PURCELL REGULATORY ASSET AND AMORTIZATION**

4 **Q. Could you please provide some background to your amortization adjustment?**

5 A. The adjustment stems from MAWC’s acquisition of the City of Purcell water and sewer
6 systems in Case No. WA-2022-0293. I’ve attached the Company’s original application to
7 purchase the water and sewer systems along with the Operation and Purchase agreements as
8 well as Staff’s Recommendation filed in that case as Schedule JSR-R-01. To briefly explain
9 this situation: The City of Purcell (“City”) could no longer provide safe and adequate water
10 and sewer service to its citizens. Therefore, the Department of Natural Resources and
11 Missouri Public Service Commission Water Department negotiated with MAWC, so that
12 MAWC would operate the systems for the City. The City and MAWC entered into an
13 Operation and Management Agreement (“OM Agreement”) under which MAWC would be
14 paid \$6,500 monthly for services and another \$500 per month for “costs associated with
15 billing and collecting revenues”. The OM Agreement included an Option to Purchase System
16 clause as well.

17 **Q. Has MAWC requested to purchase the system?**

18 A. Yes. The Commission granted MAWC a Certificate of Convenience and Necessity (“CCN”)
19 in the above referenced case.

1 **Q. Has Staff included an “acquisition regulatory asset amortization” in this case?**

2 A. Yes. Staff witness Courtney Horton testified to a monthly amortization of \$2,037 to be
3 included in the revenue requirement. The “Purcell” section of her testimony is on page 20
4 and 21 of her Direct Testimony.

5 **Q. Why has Staff made this amortization adjustment?**

6 A. MAWC answer to Staff data request 0249 indicates that the City has not kept up with its
7 monthly payments. An excel spreadsheet that accompanies the DR answer indicates that
8 MAWC has over \$203 thousand in unpaid invoices that it expects the City to reimburse. (JSR-
9 R-02).

10 **Q. What is your position on the inclusion of this \$2,037 monthly amortization?**

11 A. The inclusion of this adjustment should be denied and any regulatory asset associated with
12 this Purcell water system purchase should be denied rate base inclusion.

13 **Q. What are the reasons for denying the amortization and the regulatory asset?**

14 A. MAWC was acting as an independent contractor¹ prior to the Commission’s approval of the
15 CCN. Any dispute between MAWC and the City is a private matter between them. This is
16 not a regulatory matter to be divvied up among the entire ratepayer base. The testimony of
17 Ms. Horton as well as the answer to data request 0249 lack detail to even consider any sort of
18 adjustment. Reading the OM Agreement would leave a person to believe that at the most, the

¹ WA-2022-0293, Application Appendix A, page 5 first paragraph “relationship of Missouri-American to Purcell is that of independent contractor.”

1 City would owe \$7,000 a month for 17 months. \$119,000. MAWC has included on its data
2 request spreadsheet what appears to be payroll and some system repair and operational
3 expenses.

4 **Q. What are your proposed adjustments?**

5 A. The \$203,138 regulatory asset should not be recorded in MAWC's rate base. Therefore, there
6 will not be an asset amortization of \$2,037 included in the revenue
7 requirement.

8 **INCOME TAX EXPENSE**

9 **Q. What is your proposed adjustment to the income tax expense included in Staff's revenue**
10 **requirement?**

11 A I would argue that the Company's income tax situation warrants the exclusion of income tax
12 from the calculations.

13 **Q. Why would you seek to eliminate all the income tax expense from Staff's revenue**
14 **requirement?**

15 A. MAWC has indicated on its public Missouri Public Service Commission Annual Reports,
16 attached as Schedule JSR-R-03², that account 409.1-Income Taxes, Utility Operating Income
17 is a negative number every year.

² The Annual Reports are voluminous and the only pages that pertain to my testimony is Statement of Income for the Year and the associated tax schedule. I have included the two pages for each year 2017 through 2021. The important line item is line number 409.1 Income Tax, Utility Operating Income. The balance in that account is in parentheses indicating a negative (reduction) to expenses.

1 **Q. Could you please provide an explanation of what account 409.1 contains?**

2 A. The primary account, 409, is the income/expense account where federal and state income tax
3 amounts are recorded. Account 409.1 is the subaccount where income tax specifically
4 associated with Utility Operations is recorded. The working definition provided in the
5 Uniform System of Accounts for Class A and B Water Utilities is quoted below

6 409.1 Income Taxes, Utility Operating Income.

7 This account shall include the amount of those state and federal
8 income taxes reflected in account 409, Income Taxes, which relate to
9 utility operating income after interest charges and other tax
10 adjustments. This account shall be maintained so as to allow ready
11 identification of tax effects (both positive and negative) relating to
12 Utility Operating Income (by department), Utility Plant Leased to
13 Others and Other Utility Operating Income.³

14 **Q. What does a negative number in the 409.1 account indicate?**

15 A. A negative number on this Statement indicates that the line item in question is a reduction
16 rather than an addition to expenses. In most situations, income taxes are paid or accrued and
17 a positive number would be presented in this line item. MAWC did not owe any taxes. In
18 fact, it benefited from negative taxable income and presented income tax expense (409.1) as
19 a reduction from expenses. The reduction on the 2021 Annual Report was \$38,370,630.

³ Quoted from the National Association of Regulatory Utility Commissioners (NARUC) Uniform System of Accounts for A and B Water Utilities

1 **Q. What is the amount of income tax expense that Staff built into the revenue requirement?**

2 A. Currently, the revenue requirement calculations on Staff Accounting Schedule: 1 indicates
3 that an additional \$8,829,638 will be required for income tax expense.⁴ This is a fluid number
4 because as the revenue requirement changes with true-up and Commission allowed
5 additions/deductions, the amount of income taxes will change.

6 However, regardless of what the amount of tax is included through Staff's EMS run, the final
7 amount of income tax expense built into the rate case should be zero because as I pointed out
8 in direct testimony and will further explain below; the Company is compensated for its
9 reduction in income tax liability.

10 **Q. Getting back to the negative amount in the 409.1 account. Taxable *income* can**
11 **understandably be negative due to an assortment of factors, with accelerated**
12 **depreciation and repair expensing being the usual reasons. However, the income tax**
13 **return would show no tax due. What could cause the consistently negative income tax**
14 **effect recorded in the 409.1 account in every MAWC Annual Report you have attached**
15 **to this testimony?**

16 A. Because of the use of accelerated depreciation and repair expensing, taxable income is in fact
17 negative. The tax accrual shown in 409.1 is calculated by applying the federal tax rate to the
18 taxable income (negative). The Distribution of Taxes to Accounts, the 2nd page of the attached
19 Annual Report displays the property tax (a positive expense) and income tax accrual (a
20 negative expense). These reconcile back to the Statement of Income.

⁴ Staff presents a Total company accounting schedules as well as a breakdown of total water, sewer, water districts, etc. This amount is a total company revenue requirement. The reduction to zero will need to be applied to both Water and Sewer when the Commission ordered amounts are finalized.

1 **Q. You had mentioned that the additional tax required in this case is \$8,829,638 for both**
2 **the water and sewer revenue requirements. What was the level of income tax calculated**
3 **by Staff for the test year?**

4 A. The Missouri Final Adjusted Jurisdictional amount in Staff's EMS test year income statement,
5 in account 409.1 was a negative \$6,565,797. Staff's calculation of the required amount of tax
6 as the revenue requirement stands now is positive \$2,263,841. The difference is the
7 \$8,829,638.

8 **Q. Reviewing the final accounting schedules entered in EFIS for MAWC's prior rate case,**
9 **Case Number WR-2020-0344, shows net income available of \$119 million and current**
10 **income tax available of approximately \$29 million. In this current case, Staff calculates**
11 **\$104.5 million in income and current income tax available of negative \$6.6 million.**
12 **These are similar net income amounts but very different income tax amounts. What**
13 **could cause these totals to be so different?**

14 A. This represents a change in methodology for Staff. The difference between cases is that in
15 the current case, Staff calculated income tax by including repair expenses as a deduction to
16 the net operating income before taxes. This is consistent with how the utilities apply repair
17 expenses in the consolidated income tax returns and it is also consistent with how MAWC
18 presented its tax calculations in its work papers for the current case as well as WR-2020-
19 0344.(Schedule JSR-R-04) This greatly reduces taxable income.

20 However, Staff did not apply repair expenses to income in the 2020 case and I do not believe
21 Staff has ever applied this methodology to its tax calculations before. I am certainly in favor
22 of the application. Applying expenses in a way that is similar to the Company method, and is
23 allowable under Internal Revenue Service ("IRS") rules, is a better match.

1 **Q. Do you believe that Staff's tax calculations are an IRS normalization violation?**

2 A. No. A normalization violation would have occurred if Staff had used **accelerated**
3 **depreciation** in the calculations. The IRS differentiates repair expensing from accelerated
4 depreciation. Apparently, the Company agrees since it has included repair expensing in its
5 income tax calculations in both this case and the 2020 case.

6 **Q. Applying the repair expenses to the income does not reduce the Staff's income tax**
7 **expense to zero. How can you justify reducing the amount all the way to zero and will**
8 **that rationale comply with IRS rules?**

9 A. Two reasons. Staff seems to unilaterally apply tax to any additional income calculated outside
10 of the test year. I've already pointed out that MAWC has not had a legitimate income tax
11 liability in several rate cases. Why would Staff assume that there will be an outstanding tax
12 liability on additional income in this case when it has been proven consistently wrong in prior
13 cases? The answer to that question is that MAWC takes advantage of WSIRA and produces
14 more and more repair expense every year and negates taxable income. This is the reason for
15 no taxes due.

16 The second reason is the income tax compensation payments that I mentioned in direct
17 testimony. The payments that MAWC receives from its parent company are directly related
18 to income tax benefits. It is fair and reasonable for these payments to benefit the ratepayer as
19 well. To insure that the application stays within the IRS rules, Staff would need to calculate
20 income tax just as they have done in this case (which would be allowable under the IRS
21 normalization rules), but then the Commission would allow Staff to apply the income tax
22 compensation to the remaining balance and zero out the expense.

1 **Q. Could you summarize your income tax expense position?**

2 A. We can see from MAWC's Annual Reports that the Company reduces its operating expenses
3 by way of a negative amount of income tax. We can also note that the Company and Staff
4 both include repair expenses in the calculation of income tax expense. We also know that the
5 Company is monetarily compensated for its pro forma ability to reduce taxable income for
6 the parent company⁵. With the incorporation of repair expenses in the income tax
7 calculations, Staff has greatly reduced the income tax expense built into the rate case. By
8 simply applying a portion of the income tax compensation to the remaining tax balance,
9 income tax expense can be eliminated from the cost of service.

10 **RATE OF RETURN REDUCTION APPLIED TO WSIRA**

11 **Q. Could you explain the term "pre tax rate of return"?**

12 A. Yes. I will try to generalize the answer. The rate of return ("ROR") is the combined
13 calculations of the cost of equity and debt that make up the capital structure. The taxation is
14 the combined effective tax rate (23.84%) calculated against the equity portion of the capital
15 structure.

16 When reviewing the revenue requirement schedules for this case, the untaxed rate of return
17 range will be displayed at the top of the schedule. Staff has a range of 6.28% through 6.48%.
18 But, when you apply tax to the equity, the pre tax rate of return is somewhere near 7.62%.
19 So, the pre-tax ROR is the standard ROR with tax built into the calculation.⁶

⁵ Confidential Schedule JSR-D-03 from Riley direct testimony this case

⁶ The "pre tax rate of return" term is slightly counter intuitive when you consider that tax has been applied to the ROR.

1 **Q. How is this pre-tax ROR used in a WSIRA?**

2 A. This rate of return is applied to the total rate base calculated in the WSIRA filing to develop
3 a revenue requirement to add into existing rates. Example: \$2,000,000 of new rate base
4 multiplied by the 7.62% will generate \$152,400 of new revenue requirement from the WSIRA
5 filing. If the standard ROR (6.38% midrange) was applied then the revenue requirement
6 would be \$127,600. The difference is the tax calculation.

7 **Q. Why is tax included?**

8 A. Tax is one of the cost components that is recognized in order to produce the appropriate net
9 operating income. It is my understanding, that the statutes governing WSIRA filings,
10 §§ 393.1500 –1509 RSMo., dictate the “recovery of appropriate pretax revenues ...”⁷ A
11 portion of the definition of “Appropriate pretax revenues” in § 393.1503 RSMo. states:

12 **393.1503. Definitions.** — As used in sections [393.1500](#) to [393.1509](#), the following
13 terms shall mean:

14 (1) "**Appropriate pretax revenues**", the revenues necessary to produce net
15 operating income equal to:

16 (a) The water or sewer corporation's pretax weighted cost of capital multiplied
17 by the net original cost of eligible infrastructure system projects, including
18 recognition of accumulated deferred income taxes and accumulated depreciation
19 associated with eligible infrastructure system projects which are included in the
20 petition to establish or change a WSIRA, plus accumulated deferred income taxes
21 and accumulated depreciation associated with any eligible infrastructure system
22 projects in a currently effective WSIRA implemented pursuant to
23 sections [393.1506](#) and [393.1509](#);

⁷ § 393.1506 RSMo.

1 (b) The state, federal, and local income or excise taxes applicable to such
2 revenues;.....

3 **Q. Why are you arguing against pretax revenues if the statute appears to allow MAWC**
4 **to recover them?**

5 A. I am not arguing against pretax revenues themselves. However, I am arguing against the
6 inclusion of a tax cost that does not exist in MAWC's case and therefore should not be
7 added to pretax revenues.

8 The statute calls for the inclusion of "(b) The state, federal, and local income or excise
9 taxes applicable to such revenues." § 393.1503(1)(b) RSMo. (Emphasis added). As I
10 pointed out earlier in this testimony, MAWC does not have a tax liability. It stands to
11 reason that if MAWC does not pay taxes then taxes should not be included in the WSIRA
12 calculations. The statute calls for "applicable" taxes. § 393.1503(1)(b) RSMo. Taxes do
13 not *apply* to these revenues because tax is not a cost. In this case, I believe "[a]ppropriate
14 pretax revenues" should be without tax included.

15 **Q. So the rate of return for WSIRA is established in the general rate case. The WSIRA**
16 **ROR to be set in this case should therefore be the untaxed ROR that develops the**
17 **revenue requirement needs of this general rate case?**

18 A. Yes. If this case results in a Stipulation and Agreement, then the untaxed WSIRA ROR
19 will need to be included in the agreement.

20 **Q. Does this conclude your rebuttal testimony?**

21 A. Yes.

