**Exhibit No.:** ______________
**Issue(s):** Hedging Exclusion from the FAC/ Property Sale Losses Reducing the Rate Base/ Business Credit Reduction to Rate Base
**Witness/Type of Exhibit**: Riley/Direct
**Sponsoring Party**: Public Counsel
**Case No**.: ER-2022-0129 and ER-2022-0130

# DIRECT TESTIMONY

# OF

# JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

# EVERGY METRO, INC. D/B/A EVERGY MISSOURI METRO

**AND**

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

CASE NOS. ER-2022-0129 AND ER-2022-0130

** **
Denotes Confidential information that has been redacted

June 8, 2022

# PUBLIC

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

| | | |
|---|---|---|
| In the Matter of Evergy Metro, Inc. d/b/a Evergy Missouri Metro's Request for Authority to Implement a General Rate Increase for Electric Service | ) ) ) ) | Case No. ER-2022-0129 |
| In the Matter of Evergy Missouri West, Inc. d/b/a Evergy Missouri West's Request for Authority to Implement a General Rate Increase for Electric Service | ) ) ) ) | Case No. ER-2022-0130 |

**VERIFICATION OF JOHN S. RILEY**

John S. Riley, under penalty of perjury, states:

1. Attached hereto and made a part hereof for all purposes is my direct testimony in the above-captioned case.

3. My answer to each question in the attached direct testimony is true and correct to the best of my knowledge, information, and belief.

*/s/John S. Riley*
John S. Riley, C.P.A.
Utility Regulatory Supervisor
Office of the Public Counsel

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# DIRECT TESTIMONY

# OF

# JOHN S. RILEY

# EVERGY MISSOURI WEST, INC. D/B/A EVERGY MISSOURI WEST AND EVERGY METRO, INC. D/B/A EVERGY MISSOURI METRO

# CASE NOS. ER-2022-0129 AND ER-2022-0130

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

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

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

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

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

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

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

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

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

A. Yes, I have continued my certification for over 23 years. As a CPA, I am required to continue my professional training by attending Missouri State Board of Accountancy qualified educational seminars and classes. The State Board of Accountancy requires that I spend a minimum of 40 hours a year in training that continues my education in the field of accountancy. I am also a member of the Institute of Internal Auditors ("IIA") which provides its members with seminars and literature that assist CPAs with their annual educational requirements.

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

A. Yes I have. A listing of my Case filings is attached as JSR-D-1.

**Q. What is the purpose of your Direct testimony today?**

A. 1) I will discuss issues related to fuel hedging including how hedging costs should be accounted for. 2) I will provide an explanation and recommendation for the Commission to reduce both Evergy Metro and Evergy West's rate base by the amount of losses the Companies have incurred over the years for the unprofitable sale of business property. The rate base should be reduced to at least the amount of Net Operating Losses ("NOL") that are carried on the regulatory books for ratemaking purposes. 3) I will also provide and explain my recommendation for rate base reductions for each Company's accumulated business credits that allow the respective utility to enjoy what is essentially a permanent interest free loan.

**<u>HEDGING AND FAC INCLUSION</u>**

Q. W**hat is your position in regards to Evergy resuming its hedging programs?**

A. I take no official position on whether Evergy should or should not resume its hedging program, as this would be a management decision. It is reasonable to expect customers to temper their tolerance of hedging resumption so long as the Companies can show some restraint in its risk modeling and does not revert back to the consistently ineffective practices of the past. Evergy hedging practices should be conducted prudently, cautiously, and the Companies must follow the Stipulation and Agreement that was signed by the parties and approved in Case No. ER-2016-0156 & 0285.

**Q. Could you provide a brief history of the Companies discontinuing of the hedging programs, key points of the Stipulation and Agreement, and your understanding of the Company's intentions today?**

A. Yes. In general, the OPC opposed the continuation of the hedging for natural gas and cross hedging for purchase power because the Company efforts were ineffective and costing the ratepayers millions of dollars. I have attached my direct testimony from the 2016 case as Schedule JSR-D-02. The testimony provides background on my opposition to the Company hedging as well as a description of the manner in which the Company was conducting its hedges.

Within the ER-2016-0156 case; the Company signed the Non-Unanimous Stipulation and Agreement and agreed to cease all hedging. Below is the section of the Stipulation and Agreement that pertains to Hedging:

> 5. HEDGING & CROSS-HEDGING
>
> The Signatories agree that GMO will suspend all of its hedging activities associated with natural gas (cross-hedging related to purchased power and natural gas fuel hedging). Upon approval of this Stipulation, GMO will expeditiously proceed to unwind all of its hedges associated with natural gas. Any gains or losses from the unwinding of the natural gas hedges will be flowed through GMO's Fuel Adjustment Clause ("FAC") without disallowance. The Signatories agree GMO may resume its natural gas fuel hedging activities (but not use natural gas derivatives to cross-hedge purchased power) should the market place and/or other factors change such that resuming natural gas fuel hedging activities would be warranted. GMO agrees to notify the Commission Staff and the Office of the

> Public Counsel ("Public Counsel") if GMO decides to resume its natural gas fuel hedging activities. In the event GMO resumes natural gas fuel hedging activities, GMO will record all hedging gains to FERC Account 254, 4 Regulatory Liability and hedging losses to FERC Account 182.3 Other Regulatory Assets or FERC Account 186, Deferred Debits. This deferral is agreed upon for purposes solely described in this paragraph and does not apply to or set precedent for any other case or expense. All parties are free to argue for the ratemaking treatment of any amounts deferred under this language and the ongoing treatment of hedging costs.[1]

The paragraph stipulates that the Company may resume hedging but specifically prohibits cross-hedging resumption. The paragraph is also very clear that any results from the resumption of hedging will be recorded in regulatory asset and liability accounts with no mention of flowing costs or revenues through the FAC mechanism.

The Companies have petitioned the Commission to allow hedging for fuel as well as cross hedging for purchase power to flow through the FAC. The OPC is opposed to allowing hedging transactions to flow through the FAC at this time.

**Q. Please explain why neither hedging nor cross-hedging should be allowed to flow through the FAC.**

A. In the 2016 case, the OPC argued that the Company was costing ratepayer's millions and should not be running these losses through the FAC. Ultimately, Staff, OPC and the Companies agreed to halt all future hedging transactions. The Companies could resume hedging but the Agreement was quite clear that cross hedging was not to be resumed. The Agreement was also clear that the results of new hedging was not going to be funneled through the FAC. The Company has indicated that it intends to record hedging results through the FAC. There has been no alteration to the existing Stipulation and Agreement to allow FAC inclusion.

[1] This particular section is from the GMO rate case, however, the same language can be found in the Stipulation and Agreement entered into for Case No. ER-2016-0285, Kansas City Power & Light Company

The Evergy West hasn't even begun actual hedging transactions as of yet but insists on FAC inclusion of the results. This is unwise. We can't even guess how well Evergy will be at hedging in today's markets and it is therefore prudent not to allow these costs to flow through the FAC to prevent the problems that befell Evergy's predecessor, where poor results were funneled through the FAC with little resistance.

**Q. What is your recommendation with regard to hedging at this time?**

A. The Company may choose to hedge for natural gas prices with no cross-hedging, but the results, good or bad, should be recorded in the regulatory asset/liability accounts and dealt with in the next general rate case. By then all parties will have a better understanding of how Evergy performs in the hedging arena.

**RATE BASE ADJUSTMENT FOR LOSS ON SALE OF BUSINESS PROPERTY**

**Q. What is a loss on the sale of business property?**

A. The property in question was used in the trade or business of the Company. This is a tax return item. It represents a reduction in the overall income total of the business.

**Q. What is the nature of the business property that the Companies have been selling?**

A. The assets being sold are general utility assets that are for whatever reason no longer useful.

**Q. Where do you locate and identify this "discarded" utility property?**

A. On the Company's consolidated federal tax return, specifically Form 4797, **Sale of Business Property** and its associated schedules. The sales are listed in asset groupings, such as Office Equipment, Distribution, Production Plant, Railcars and Transportation. The Statement has separate columns for cost, depreciation allowed, sale price and gain/loss. Each group is summarized and the total balance is transferred to Income section (line 9) of the main page of the tax return (Form 1120). This total is almost always a loss. So a Company's list of incomes will have one line item reduction (loss) in the income section.

**Q. Why would the loss on the sale of obsolete business property raise any concern?**

A. Several reasons. The dollar value of the loss is usually substantial. There is a loss recorded nearly every year. The property in question is utility plant and equipment that ratepayers have funded and hasn't been fully depreciated on the financial records. Still having an undepreciated cost on the books and records would indicate that the assets still have value. The reduction in net income for the loss directly affects the amount or the use of the Company's net operating loss ("NOL"). In utility rate base, the NOL is an addition to plant and therefore an increase in revenue requirement for the Company in question.

**Q. Could you provide more detail about how this loss, a reduction in income, affects the NOL?**

A. The property sale losses are a reduction in taxable income. For tax purposes, those reductions in income mostly come from the business expenses. If taxable expenses exceed total taxable revenues then a tax loss is generated ("NOL"). Usually, we think of NOLs to be associated with accelerated depreciation but several factors can contribute to a taxable loss. The loss on the Sale of Business Property is one of those factors. Let's use a short example:

| | | |
|---|---|---|
| Utility Company A has gross profits of | $100,000 | |
| Interest income of | $ 10,000 | |
| Capital gains of | $ 5,000 | |
| Loss on Sale of Property | ($15,000) | |
| Total Income | **$100,000** | |
| | | |
| Utility Company A has salaries of | $25,000 | |
| Interest expense | $30,000 | |
| Depreciation | $40,000 | |
| Other Deductions | $10,000 | |
| Total Expenses | **$105,000** | |
| Taxable Income | | **($5,000) loss** |

It can quickly be determined that without a Loss on Sale of Business Property of $15,000, the Utility would have made a taxable profit of $10,000. Instead, there is a $5,000 loss which will be recognized as an NOL for regulatory purposes. The property sale loss contributes to the NOL balance.

Another example:

| | | |
|---|---|---|
| Utility Company A has gross profits of | $150,000 | |
| Interest income of | $ 10,000 | |
| Capital gains of | $ 5,000 | |
| Loss on Sale of Business Property of | ($ 15,000) | |
| Total Income | **$150,000** | |
| | | |
| Utility Company A has salaries of | $25,000 | |
| Interest expense | $30,000 | |
| Depreciation | $40,000 | |
| Other Deductions | $10,000 | |
| Total Expenses | **$105,000** | |
| Taxable Income | | **$45,000** |
| | | |
| Assume that the Company has an NOLC of | $50,000 | $45,000 NOL applied |
| Taxable Income is | | 0 |
| Company still has $5,000 as an NOLC | | |

If the Company didn't have utility plant sales of ($15,000) then the Total Income would have been $60,000 and Company A would have exhausted the entire NOL balance of $50,000 and still would have owed income tax on $10,000. In these examples, the Loss on Sale of Business Property has helped <u>create</u> an NOL balance and in the second part, <u>retain</u> an NOL balance.

**Q. The only time an income tax return comes into the regulatory discussion is to track the balance of NOL from year to year. Why should the Commission pay attention to Form 4797 losses?**

A. Because these line item losses essentially reduce income taxes for the Company but Staff does not reflect this in the Income Tax calculations within the Accounting Schedules.

Historically, the Commission has been reflecting NOL balances in rate base. If the Commission were to acknowledge that property sale losses extend the life of the NOL then the NOL should be reduced by the accumulation of those losses. It stands to reason that the ratepayer should benefit from this tax reduction since it has funded the assets in question and provided a rate of return on those assets and paid the associated taxes on the return.

**Q. Is there any concern that your recommendation will violate the so-called "normalization rules?"**

A. The normalization rules require that the NOL must be related to accelerated depreciation. Reducing the NOL by the losses from Form 4797 in no way damages that relationship. I can find no other instances where the argument that I am now presenting has been made previously. It certainly isn't in the Company's interest to recognize this offset.

**Q. What adjustments are you proposing for Evergy West and Metro?**

A. Review of Great Plains Energy consolidated income tax returns as well as Evergy tax returns and answers provided with OPC data requests indicate that Evergy West and its predecessor GMO have combined to record over **__________ ** in losses on sales of business property since 2017. Evergy Metro and its predecessor Kansas City Power & Light have accumulated over ** __________ ** in that same time. So the overall adjustment is to apply these balances to the NOL balances.

**Q. What NOL balances have the Companies included in rate base?**

A. Evergy West has an NOL balance in rate base of $45,761,624. Evergy Metro has a $76,293,093 balance of NOL in rate base.

**Q. What conclusion do you draw from these Form 4797 loss balances?**

A. The respective loss balances accumulated since 2017 have far exceeded the NOL balances that the Companies would include in the rate base. The NOL balances should be reduced to zero.

## BUSINESS CREDITS DEDUCTION TO RATE BASE

**Q. Could you summarize your position on the application of general business credits in the revenue requirement process?**

A. I contend that the general business credits that have been generated courtesy of the federal government are essentially permanent interest free money. Through the ratemaking process these credits are ultimately funded by the ratepayer. This funding is very similar to deferred income tax (ADIT) and should therefore be reflected in rate base as a reduction.

**Q. Could you explain the idea that a tax credit is similar to "interest free money"?**

A. The federal government incentivizes Companies to invest money. The IRS allows accelerated depreciation to provide tax breaks to encourage investment in plant. We recognize this as ADIT. When the government wants investment in other projects it deems important it creates incentives by way of tax credits. Renewable energy may be the most prominent in the current atmosphere but there are several that utilities can take advantage of. Without getting into the particulars, companies generating these credits apply them to their tax liability. Accelerated depreciation and tax credits are applied differently but the results are the same – a reduction to the tax liability that the Company is required to pay.

The big difference in the two is that ADIT eventually "turns around" and the Company eventually pays the tax over the life of the asset. Tax credits have no turn around. Tax credits are much like NOLs in that they just sit on the books until they are needed. They have no amortization and no expiration. The idea that credits are free money is that the Company collects these unexpiring tax breaks through their ratepayer funded operations.

The Company didn't pay for these tax reducing credits, the ratepayer does. The application of these credits goes directly to the bottom line – permanently.

**Q. A review of Evergy's most recent tax return (2020) indicates that the Company is active in using these credits to reduce current taxes. Why propose rate base treatment?**

A. Simply because Metro and West have accumulated balances that will not be depleted by the next rate case. The annual application of these taxes should be reflected as a reduction in the income tax expense built into the case, however, the balance should be reflected in rate base just as ADIT is recognized.

**Q. What are the current balances of business tax credits for Metro and West?**

A. The Company provided a confidential answer to OPC data request 1314 (Schedule JSR-D-03) and indicated that with the 2020 federal tax return, Metro had a balance of ** ____________ ** and West had a balance of ** __________ **.

**Q. Are you proposing that these balances be a reduction to each Company's rate base?**

A. Yes.

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

A. Yes.