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OPC – Exhibit 300
John S. Riley Testimony
Direct
Case No. WR-2025-0345

Exhibit No.:

Issue(s):

Witness/Type of Exhibit:

Sponsoring Party:

Case No.:

Tax Gross Up

Riley/Direct

Public Counsel

WR-2025-0345

DIRECT TESTIMONY

OF

JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

FILE NO. WR-2025-0345

December 30, 2025

DIRECT TESTIMONY

OF

JOHN S. RILEY

CASE NO. WR-2025-0345

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 19th 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. 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

1 my education in the field of accountancy. I am also a member of the Institute of Internal
2 Auditors (“IIA”) which provides its members with seminars and literature that assist CPAs
3 with their annual educational requirements.

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

5 A. Yes, I have. A listing of my case filings and certification is attached as JSR-D-01.

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

7 A. To address the inclusion of a tax gross-up amount in the revenue requirement for this Water
8 and Sewer Infrastructure Rate Adjustment (“WSIRA”) filing for Missouri American Water
9 Company (“Missouri-American” or “MAWC”). As explained further below, the tax gross up
10 is typically calculated and included in the ratemaking revenue requirement to ensure that a
11 company is allowed an opportunity to recover its full Commission-authorized income, even
12 after it pays income taxes. However, not every utility or case requires a tax gross-up
13 calculation. The Commission should determine its inclusion on a case-by-case basis. Here,
14 MAWC does not pay income tax and will not do so for the foreseeable future. For this reason,
15 the inclusion of the tax gross up in this case is overcompensating and unnecessary. The
16 Commission should disallow the amount included for the tax gross up in this case, which
17 amounts to \$430,535 from Staff’s calculation, as explained in my memorandum attached to
18 the OPC’s Response to Staff’s Recommendation.¹

19 **Q. Could you please walk us through the tax gross-up process?**

20 A. Yes. In our traditional rate base, rate of return revenue requirement, the Commission
21 determines a fair and reasonable amount of income that the company has the opportunity to
22 earn. Let’s just use some easy, round numbers to illustrate this. The Commission sets rates
23 so that the company has the opportunity to earn \$100,000.

¹ My memorandum is attached as Schedule JSR-D-02.

Illustrative Example	
Commission-Approved Revenues	\$100,000

Now, the difference with ratemaking as opposed to private industry is that in private practice you would deduct taxes from the total Commission-approved revenues, so \$100,000 less 23.84% (standard composite tax rate) or \$23,840 = net income of \$76,160. However, in ratemaking, the Commission intends for the utility to retain \$100,000 after taxes are calculated. Therefore, additional money is included in the revenue requirement to ensure the company keeps \$100,000 after taxes. This additional amount can be calculated using either a long-form calculation or a simplified equation. I will explain both below.

Long-Form Calculation

To achieve this using the long-form calculation, the first step is to add in the amount of the income taxes themselves to the revenues. In the simplified example, \$23,840 is added to pay the income taxes on the \$100,000.

Illustrative Example	
Commission-Approved Revenues	\$100,000
Income Taxes (\$100,000*.2384)	\$23,840

Importantly though, the Internal Revenue Service (“IRS”) does not see the income tax expense as just another cost. Rather, it views the \$23,840 as additional taxable revenues for the company. Therefore, assuming that the company will actually pay the income tax amount to the IRS, additional tax needs to be added to the revenue stream to cover the tax generated from the additional \$23,840 (tax on tax). To calculate this additional amount of tax, one

multiplies the \$23,840 of additional “income” (collected to pay the income taxes on the original \$100,000 of revenue) by the composite tax rate of 23.84%. This results in additional income taxes of about \$5,683.

Illustrative Example	
Commission-Approved Revenues	\$100,000
Income Taxes (\$100,000*.2384)	\$23,840
Income Taxes due on Collected Income Taxes (1) (\$23,840*.2384)	\$5,683

However, the calculation does not stop there. The additional \$5,683 also creates more taxable revenues. To calculate the additional tax owed on that amount one multiplies the \$5,683 by the composite tax rate of 23.84%. This results in an additional approximately \$1,355 that must be added to the revenue requirement.

Illustrative Example	
Commission-Approved Revenues	\$100,000
Income Taxes (\$100,000*.2384)	\$23,840
Income Taxes due on Collected Income Taxes (1) (\$23,840*.2384)	\$5,683
Additional Income Taxes due on Collected Income Taxes (1) (\$5,683*.2384)	\$1,355

This pattern then repeats until the results are negligible. The final addition of all these long-hand calculations results in the tax amount to compensate for the tax on tax. This allows the company the opportunity to collect the full amount of its Commission-authorized revenues while paying the income taxes owed on the amount it collects. Eventually, one finds that the company must collect approximately \$131,300 to recover its full Commission-authorized revenues.

Illustrative Example	
Commission-Approved Revenues	\$100,000
Income Taxes (\$100,000*.2384)	\$23,840
Income Taxes due on Collected Income Taxes (1) (\$23,840*.2384)	\$5,683
Additional Income Taxes due on Collected Income Taxes (1) (\$5,683*.2384)	\$1,355
Additional Income Taxes due on Collected Income Taxes (2) (\$1,355*.2384)	\$323
Additional Income Taxes due on Collected Income Taxes (3) (\$323*.2384)	\$77
Additional Income Taxes due on Collected Income Taxes (4) (\$77*.2384)	\$18
Additional Income Taxes due on Collected Income Taxes (5) (\$18*.2384)	\$4
Total to Collect	\$131,300

The pattern discussed above is calculating tax on tax. Another way of defining this tax on tax is to, “gross-up” the tax. This can also be achieved using a simplified equation.

Simplified Equation

Instead of having to do this long-form calculation with every revenue requirement, a formula makes a short cut of this process by multiplying the Commission’s approved revenues, in this example \$100,000, by 1.313.² With this calculation, one determines that the company in the above example must collect rates that will allow it to recover \$131,300 so the company is given the opportunity to recover its full Commission-authorized revenues of \$100,000. The 1.313 used in the gross-up calculation is the cumulation of multiplying tax by the tax rate several times over. The formula takes the work out of the calculations.

Illustrative Example	
Commission-Approved Revenues	\$100,000
Tax Rate (Gross-Up Included)	1.313
Total to Collect	\$131,300

Using either the long-form calculation or the simplified calculation, the result is the same. In this example: Rates need to be set to collect \$131,300 so that the company has the opportunity earn its full \$100,000 in Commission-authorized revenues.

² These rate calculations for the composite tax rate, pre-tax weighted cost of capital (WACC) and the gross-up factor are attached as JSR-D-03.

1 **Q. You pointed out in your opening that this gross-up is unnecessary for Missouri-**
2 **American in this case. Why?**

3 A. This additional tax gross up is unwarranted when Missouri-American is involved because it
4 does not currently owe income taxes to the IRS, therefore it does not pay income taxes. It
5 will be in this situation for the foreseeable future.

6 To be clear, whether this tax gross up is included in a revenue requirement calculation should
7 be determined on a case-by-case basis, as it is not necessary in every rate case. Specifically,
8 some utilities owe (pay) income taxes and, to return to my example above, to ensure that their
9 \$100,000 income is collected, a gross-up calculation is required.

10 **Q. How do you know that Missouri-American does not currently and will not for the**
11 **foreseeable future owe income taxes?**

12 A. MAWC is different from some other utilities because it will not owe income tax for the
13 foreseeable future. This is shown in Staff Accounting Schedules along with MAWC's Pro
14 Forma Current income tax Schedules from its most recent rate case, Case Number WR-2024-
15 0320. It is also shown in MAWC's 2023 Annual Report to the Commission. These are
16 included as Schedule JSR-D-04.

17 **Q. Missouri-American is not currently required to pay income tax. How does this relate to**
18 **the gross-up explanation you provided earlier?**

19 A. As I demonstrated above, a tax gross-up is calculated to ensure that a company is capable of
20 recovering its Commission-authorized income of \$100,000 by taxing the additional amount
21 recovered to pay the income taxes due on the initial \$100,000.

1 Let's walk through this scenario. If the Commission determines Company X is allowed to
2 earn \$100,000. Staff calculates income tax due on the proposed \$100,000, which is \$23,840³.
3 As explained before; the \$23,840 is considered taxable revenue by the IRS. Therefore, in
4 *theory*, the company should also collect an amount to pay the tax on the additional \$23,840.

5 But what if there is not any tax due on the additional \$23,840, should there be a gross-up
6 collected on an unpaid tax expense? I argue, no.

7 This is the situation with Missouri-American and why I argue the Commission should
8 disallow the amount associated with the tax gross up in this case.

9 **Q. You have just stated that the IRS considers the \$23,840 income tax expense as taxable**
10 **revenues. Why would you not include an additional amount to cover the additional tax**
11 **on these revenues?**

12 A. The Commission should not include the additional amount in this case because MAWC never
13 pays the amount it collects to pay taxes to the IRS. Because MAWC never pays this amount
14 to the IRS, why should the customer pay for a gross-up on something not owed?

15 I have already pointed out that MAWC will not owe taxes in the foreseeable future, so, using
16 the numbers from the example above, it will not have to pay the \$23,840 collected on the
17 \$100,000 income. Trying to demand additional taxes to pay nothing, is wrong.

18 **Q. You made a similar argument in the general rate case, Case Number WR-2024-0320,**
19 **and Company witness Ms. Linda Schlessman contested you. How is this different?**

20 A. It really is not much different, but Ms. Schlessman did a very good job of twisting the
21 situation. Her testimony from that argument is below:

³ No one is arguing the validity of the original income tax being included in rates. This testimony is an argument against the additional tax calculations only.

V. GROSS-UP ON THE REVENUE REQUIREMENT

Q. OPC Witness Riley states that a gross-up on tax is not required because the Company is not in a taxable situation. Is this correct?

[A]. No. The Company does have tax expense and is including the amount in the revenue requirement. Tax expense includes both current and deferred taxes. The absence of current tax expense does not mean the Company is not in a taxable situation. The Company has deferred tax expense which it must pay to the government in the future and therefore has taxes to collect from customers. The gross-up on tax expense ensures that the Company is made whole because taxes collected in the revenue requirement are not deductible. Therefore, each dollar of tax collected in the revenue requirement will also be taxed. Below is an illustration that demonstrates the importance of a gross-up in the revenue requirement. As demonstrated in the example, the Company will not meet its authorized revenue requirement without a gross-up rate applied to income tax expense.⁴

Q. What is your response to Ms. Schlessman's argument?

A. Her whole response to the question has no context. In the first line of her response, she mentions income tax expense is built into the revenue requirement. However, it is understood from Staff accounting schedules, MAWC work papers, income tax returns and the Annual Report, that MAWC does not currently *pay* income tax to the IRS.

Her second sentence states "The Company has deferred tax expense which it must pay to the government in the future and therefore has taxes to collect from customers." However, MAWC has already collected these deferred taxes from its ratepayers in advance, that is what

⁴ Case No. WR-2024-0320, Linda Schlessman Rebuttal/Surrebuttal/Sur-Surrebuttal Testimony, page 13, lines 4-16.

1 Accumulated Deferred Income Taxes are⁵. When these deferred taxes eventually come due
2 then the necessary tax gross-up will be applied to the taxes owed.

3 Her third sentence states “The gross-up on tax expense ensures that the Company is made
4 whole because taxes collected in the revenue requirement are not deductible.” In this sentence,
5 she fails to mention that taxes collected are not required to be paid to the IRS. I have pointed
6 to several sources that show that Missouri-American does not currently pay income taxes and
7 will not do so for the foreseeable future. Therefore, deductibility is not an issue. If MAWC
8 was the company in the example in the beginning of my testimony it was made whole when
9 the Commission authorized it to recover the \$100,000. This is so because it does not currently
10 owe any taxes on its income and will not do so for the foreseeable future. MAWC does not
11 pay to the IRS any of the taxes included in the revenue requirement to ensure that it is “made
12 whole.” Rather, its ratepayers have provided it with an interest free loan on its deferred tax
13 and when those deferred taxes reverse, its ratepayers will be charged those taxes when they
14 become due. Any income tax actually owed on future earnings will have a gross-up
15 calculation added.

16 **Q. Could you summarize your testimony?**

17 **A.** Missouri-American and Staff have both included a tax gross-up in their revenue requirement
18 calculations for this case, but as I have explained not all cases require this extra step. A tax
19 gross-up is only necessary when taxes are actually paid because tax payments necessitate
20 additional (gross-up) tax payments. Not every utility and not every case needs a tax gross-up
21 and determining whether it is required should be done on a case-by-case basis, not carte
22 blanche. Here, because MAWC pays no income taxes, the tax gross up should be excluded
23 from the revenue requirement calculation in this case.

⁵ Deferred taxes are collected from the ratepayer, in advance through rates, creating the interest free loan. Eventually, the deferral reverses and the pre-collected funds pay the taxes that come due. A tax gross-up will then be added to the total if needed.

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

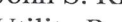
2 A. Yes.

In the Matter of the Petition of Missouri-)
American Water Company for Approval to)
Establish a Water and Sewer Infrastructure Rate) Case No. WR-2025-0345
Adjustment (WSIRA))


STATE OF MISSOURI)
) SS
COUNTY OF COLE)

1. My name is John S. Riley. I am a Utility Regulatory Supervisor for the Office of the Public Counsel.

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

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


Tiffany Hildebrand
Notary Public