

Exhibit No.: OPC 6
Issue(s): Net Operating Loss (NOL)
Witness/Type of Exhibit: Riley/Direct
Sponsoring Party: Public Counsel
Case No.: WO-2018-0373

11-20-18 BJB

DIRECT TESTIMONY

OF

JOHN S. RILEY

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WO-2018-0383

November 13, 2018

OPC Exhibit No. 6
Date 11-20-18 Reporter BSB
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MISSOURI-AMERICAN WATER COMPANY
CASE NO. WO-2018-0373

1 **INTRODUCTION**

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

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

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

5 A. I am employed by the Missouri Office of the Public Counsel ("OPC") as a Public Utility
6 Accountant III.

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

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

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

11 A. I was employed by the OPC from 1987 to 1990 as a Public Utility Accountant. In this capacity
12 I participated in rate cases and other regulatory proceedings before the Public Service
13 Commission ("Commission"). From 1994 to 2000 I was employed as a tax auditor with the
14 Missouri Department of Revenue. I was employed as an Accounting Specialist with the
15 Office of the State Court Administrator until 2013. In 2013, I accepted a position as the Court
16 Administrator for the 19th Judicial Circuit until April, 2016 when I joined the OPC. Since
17 2015, I have also prepared individual and small business tax returns for a local accounting
18 and tax preparation service.

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

2 A. Yes, I have held a license for over 20 years and I am also a member of the Institute of Internal
3 Auditors (“IIA”)

4 **Q. Have you previously filed testimony before the Missouri Public Service Commission**
5 **(“Commission” or “PSC”)?**

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

7 **NOL EXCLUSION**

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

9 A. I explain what Net Operating Loss (“NOL”) is, and elaborate on the importance of excluding
10 NOL from a company’s Infrastructure System Replacement Surcharge (“ISRS”) calculations
11 for rate base and cost of service. I also concur with Staff’s recommendation to remove
12 Missouri American Water Company’s (“MAWC” or “Company”) purported NOL from the
13 ISRS revenue calculation.

14 **Q. Could you state what the term Net Operating Loss means and explain how a company**
15 **may use NOL accounting for income tax purposes?**

16 A. First and foremost, an NOL is a tax return adjustment not a regulatory item. Specifically, an
17 NOL is an accounting fiction where, for income tax purposes, a company reports deductions
18 that are higher than reported revenues. This is an item the Company recognizes on its tax
19 return as a taxable income loss. Typically a regulated utility does not incur losses in its regular
20 course of business. One of the major reasons “losses” are incurred for tax purposes is due to
21 the Internal Revenue Service rules that allow the use of accelerated depreciation when
22 determining taxable income. The Commission sets rates by applying a standard depreciation
23 rate that encompasses the expected life of the assets. An example of this would be plant

1 additions that are expected to have a useful life of 30 years are depreciated over 30 years,
2 while for tax purposes, this new addition would be depreciated over five years. This
3 difference creates a much higher deduction when determining taxable income but a much
4 lower expense for regulatory accounting of income.

5 **Q. Why did Staff disallow the NOL in the ISRS calculations?**

6 A. Staff removed the \$9,368,663 NOL due to it being an unsubstantiated calculation. It is my
7 understanding that the beginning timeframe for this ISRS calculation period is January 1,
8 2018. Essentially, Staff's argument is that there cannot be an NOL applied to the ISRS
9 investment because there is no tax return filed that covers the timeframe in question. To
10 quote Staff's Revenue Calculation Section, point number 3

11
12 3. Removal of MAWC's proposed net operating loss ("NOL") of
13 \$9,368,663 that has been used to offset the deferred tax liability
14 related to this ISRS investment. As of this date, Staff's
15 understanding is that no amount of net NOL has actually been
16 generated for income tax purposes by MAWC on an aggregate basis
17 since January 1, 2018 (the beginning of this ISRS period).
18 Alternatively, Staff has not been presented with any evidence that
19 imputation of a "hypothetical" NOL amount into ISRS rate base in
20 this case is required to comply with the normalization provisions of
21 the Internal Revenue Service Code.

22
23 As was pointed out earlier in my testimony, an NOL is a tax return item and no tax return has
24 yet been filed that covers this timeframe so no NOL should yet be claimed. Staff's conclusion
25 is accurate for this report. This argument does not need any further explanation, however,
26 additional points should be presented to distinguish an NOL from any sort of ISRS
27 consideration.

1 **Q. What other points should be considered?**

2 A. An NOL, as a tax return item, has nothing to do with the Company's infrastructure or plant
3 additions. As a result, an NOL has no connection to the Infrastructure System Replacement
4 Surcharge. If an NOL were actually to be considered, its possible inclusion would need to be
5 addressed in a rate case, not an ISRS proceeding.

6 Another limitation that excludes an NOL from ISRS consideration is that an NOL is not asset
7 specific and cannot be tied to any specific ISRS qualifying or non-ISRS qualifying
8 infrastructure investment. This is in contrast to identifying deferred tax liability to an asset.¹

9 **Q. Could you explain the difference between the recognition of the deferred tax and the**
10 **NOL?**

11 A. A deferred tax liability is the difference between the tax amounts generated from accelerated
12 depreciation verses the tax calculated on regulatory depreciation. As previously established,
13 depreciation expense is higher when using IRS allowed accelerated depreciation as opposed
14 to the standard regulatory rates. A simple example to illustrate the difference would be that
15 a Company installs water lines costing \$1,000. Five years of Internal Revenue Service-
16 allowed accelerated depreciation deduction is \$200 a year. For regulatory purposes, say the
17 rate is 20 years or \$50 a year. At 21%, the tax expense savings for \$200 is ($\$200 \times 21\% =$
18 $\$42$). The tax calculated for regulatory purposes is ($\$50 \times 21\% = \10.50) the deferred tax is
19 $\$31.50$ on the specific asset in this example. The same example cannot be used to identify an
20 NOL to this specific \$1000 asset.

21 An NOL, a tax return item, is the by-product of the summation of greater expenses (deductions
22 and credits) than the revenues (taxable income) reported for an entire tax return, not just an

¹ OPC has argued in prior cases that an NOL should not be included in rate base or the cost of service, however, we are limiting our argument in this case to the exclusion of an NOL in the ISRS calculation. Regulatory assets are recorded at cost not market value. The utility expended no monies to acquire the NOL asset which has no cost basis.

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1 isolated item. In this case, the income tax liability is the product of a consolidated tax return
2 which is impacted by other entities besides the Missouri regulated utility. Even though the
3 accelerated depreciation plays a major part in a company's taxable income loss, there are still
4 many other factors that contribute to the Company's claimed NOL which are totally unrelated
5 to the \$1000 asset.

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

7 **A. Yes it does.**

John S. Riley, CPA
Summary of Case Participation

ST LOUIS COUNTY WATER COMPANY	CASE NO. WR-88-5
SOUTHWESTERN BELL TELEPHONE COMPANY	CASE NO. TC-89-21
EMPIRE DISTRICT ELECTRIC COMPANY	CASE NO. ER-2016-0023
KCP&L GREATER MISSOURI OPERATIONS COMPANY	CASE NO. ER-2016-0156
KANSAS CITY POWER & LIGHT COMPANY	CASE NO. ER-2016-0285
AMEREN MISSOURI	CASE NO. ER-2016-0179
EMPIRE DISTRICT ELECTRIC PRUDENCE REVIEW	CASE NO. EO-2017-0065
LACLEDE GAS COMPANY	CASE NO. GR-2017-0215
MISSOURI AMERICAN WATER COMPANY	CASE NO. WU-2017-0351
MISSOURI AMERICAN WATER COMPANY	CASE NO. WR-2017-0285
EMPIRE DISTRICT ELECTRIC COMPANY	CASE NO. EO-2018-0092
LIBERTY (MIDSTATE NATURAL GAS)	CASE NO. GR-2018-0013
KANSAS CITY POWER AND LIGHT	CASE NO. ER-2018-0145
KCP&L GREATER MISSOURI OPERATIONS COMPANY	CASE NO. ER-2018-0146
EMPIRE DISTRICT ELECTRIC PRUDENCE REVIEW	CASE NO. EO-2018-0244
EMPIRE DISTRICT ELECTRIC COMPANY	CASE NO. ER-2018-0228
EMPIRE DISTRICT ELECTRIC COMPANY	CASE NO. ER-2018-0366