

# EXHIBIT

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Sponsoring Party: Public Counsel  
Case No.: WO-2019-0184

## REBUTTAL TESTIMONY

OF

JOHN S. RILEY

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Missouri Public  
Service Commission

Submitted on Behalf of the Office of the Public Counsel

**MISSOURI-AMERICAN WATER COMPANY**

CASE NO. WO-2019-0184

May 13, 2019

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**REBUTTAL TESTIMONY**

**OF**

**JOHN S. RILEY**

**MISSOURI-AMERICAN WATER COMPANY**

**CASE NO. WO-2019-0184**

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 Public Utility  
5 Accountant III.

6 **Q. Are you the same John S. Riley that filed direct testimony in this case?**

7 A. Yes.

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

9 A. The purpose of my testimony is to refute Missouri American Water Company ("MAWC" or  
10 "Company") witness John R. Wilde's assertions in his direct testimony regarding the  
11 proposed inclusion of the Company's hypothetical net operating loss ("NOL") in MAWC's  
12 Infrastructure System Replacement Surcharge ("ISRS") calculations. I explain that the  
13 company did not generate any NOL during the ISRS timeframe of October 1, 2018 through  
14 March 31, 2019. I also discuss the fact that the Commission's exclusion of an NOL in this  
15 case does **not** deny the company the benefit of using the interest free accumulated deferred  
16 income tax ("ADIT"). Further, I explain that excluding an NOL does not violate the Internal  
17 Revenue Service ("IRS") normalization rules.

1 **LACK OF NOL DURING ISRS PERIOD**

2 **Q. Was MAWC in an income tax loss situation during the October 1, 2018 through March**  
3 **31, 2019 ISRS period?**

4 A. No, they were not. Rarely does a regulated utility have an actual financial loss and as I explain  
5 below MAWC is certainly not in that situation here.

6 **Q. How do you know?**

7 A. There is a simple explanation. An income tax loss, otherwise referred to as an NOL, is an  
8 **income tax return generated event.** An income tax reportable loss occurs when a  
9 corporation's consolidated tax deductions surpasses the taxable income included on its annual  
10 income tax return. American Water Works ("AWW") can only claim an NOL upon  
11 completion and filing of its consolidated federal or state income tax return. On behalf of the  
12 consolidated companies, AWW will file its 2018 federal income tax return in September 2019.  
13 Until that time, AWW has not reported any income tax generated event. Stated another way,  
14 AWW has not filed with the IRS a return that shows any income or expenses that correspond  
15 to the ISRS timeframe at issue, meaning that MAWC cannot demonstrate an NOL occurred  
16 during this period.

17 **Q. Do you agree with MAWC's argument that an NOL should be included in the ISRS**  
18 **calculations?**

19 A. No. Mr. Wilde contends that MAWC's NOL carryover balance from **prior periods** should  
20 be factored into the ISRS-eligible investment.

21 **Q. How do you respond to this argument?**

22 A. An ISRS proceeding is a statutorily authorized, single issue, time specific, ratemaking. Staff  
23 calculates all of the costs then calculates the company's ROE on specific ISRS eligible

1 infrastructure constructed within a specific timeframe. For Mr. Wilde to argue that a prior  
2 period NOL balance should be included in the calculations presents several inconsistencies  
3 with established regulatory and accounting principles.

4 **Q. What principles would be violated?**

5 A. The matching principle would be the first violation that comes to mind. NOLs are not asset  
6 specific. NOLs are, instead, an accumulation of tax deductions filed on a tax return, so to  
7 point at a specific ISRS-eligible asset, which notably, has a **profit** calculation built into the  
8 total, and to say there should be a loss attached to the total is a mismatching of values.

9 The cost principle would be another violation. An NOL has no cost attached to it. No money  
10 was expended to produce an NOL. In the nonregulated business sector, an NOL is recorded  
11 as an asset on the balance sheet because it has value. The value is that the NOL can actually  
12 be applied to taxable income, to reduce future income taxes payable. In that respect, recording  
13 an NOL recognizes a future savings in tax costs. In contrast, regulated utilities' customers are  
14 paying income tax expense in rates. Not only are deferred income taxes built into rates, but  
15 income tax expense for Commission authorized profits are also built into consumers' rates.

16 **EXCLUSION OF AN NOL DOES NOT REDUCE INTEREST FREE MONEY**

17 **Mr. Wilde has stated in his direct testimony in the prior case, WO-2018-0373 and the**  
18 **current case:**

19 The intent of Congress in creating the normalization rules, is to  
20 provide the utility an interest free source of funds to invest in utility  
21 property. To the extent that the utility does not receive this interest  
22 free source of funds because taking the accelerated depreciation  
23 deduction causes a taxable loss, that taxable loss needs to be  
24 included in the numbers so that the customers are not benefiting  
25 before the utility company receives the benefits.<sup>1</sup>

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<sup>1</sup> Wilde direct testimony, WO-2018-0373, page 6, lines 3-9; WO-2019-0184, page 5, lines 19-24

1 **Q. How do you respond to this quote?**

2 A. Mr. Wilde has implied that the ratepayer would prematurely benefit from reduced rate base  
3 if the NOL is not recognized. This is a misstatement of fact. The exclusion of an NOL in  
4 no way impedes the company's use of interest free funds and the ratepayer does not receive  
5 any premature benefit from this action.

6 An example may be helpful to illustrate how deferred taxes (interest free funds) are  
7 accumulated and normalized. Schedule JSR-R-1 provides a simple illustration that  
8 demonstrates the accumulation of deferred tax and also how it is normalized through  
9 regulatory processes.

10 **Q. Will you provide a narrative to help with the example?**

11 A. Yes. The parameters are straightforward. There is one \$ 100,000 plant asset (rate base) placed  
12 into service, which has a useful life of 10 years. Actual net income is not important to show  
13 how ADIT is calculated correctly, however, \$100,000 net income will be used to help  
14 visualize the income tax accounting entries for years 1-5 and 6-10.

15 Regulatory depreciation is \$10,000 annually (\$100,000/10), while in contrast, for tax purposes  
16 accelerated depreciation is \$20,000 a year for five years. In the illustration, the accelerated  
17 depreciation for taxes creates a difference of \$2,100 in taxes payable (\$16,800) in contrast to  
18 the income tax expense allowed in rates (\$18,900). This difference is a benefit to the utility  
19 because the Commission considers this ADIT to be interest-free money the Company may  
20 use. Accordingly, the Commission reduces rate base by this amount to reflect the Company's  
21 benefit of interest free use of this depreciation difference. This difference will occur in each  
22 of the first five years until the accelerated depreciation is exhausted and the plant has a zero  
23 value for tax purposes. The annual \$2,100 difference in taxes accumulates (ADIT) each year  
24 for the first five years, totaling \$10,500.

1 Schedule JSR-R-1 presents a simple yet accurate description of the normalization accounting  
2 established by IRS regulations. The IRS Normalization method of accounting requires that a  
3 reserve account<sup>2</sup> be established to record this difference in tax expense/payable created by the  
4 use of different depreciation methods for rates and taxes.

5 **Q. What happens to the ADIT balance in your illustration after year five?**

6 A. The tax benefit reverses and flows back through the ADIT account for the remaining  
7 regulatory life of the asset. This is the essence of the normalization principle - benefits build  
8 up with accelerated depreciation and reverse over the asset's remaining life when the  
9 accelerated depreciation expires. The key point that is not readily apparent in the IRS  
10 regulation or in my example, is that the accumulation of deferred tax or the gradual return of  
11 that tax after-year-five, is not adjusted by the utility's net income. So if income does not alter  
12 the flow of ADIT the Company cannot claim it is denied full use of the interest free money  
13 by having an NOL.

14 **Q. If net income is not a factor then how is deferred tax calculated and normalized?**

15 A. Deferred tax is calculated on the *difference* between using accelerated depreciation for taxes  
16 and the straight-line depreciation for regulatory purposes. The quotation below from *IRS*  
17 *section 168* contains no reference to income in the calculation of regulated tax expense.  
18 Instead, it requires the utility (taxpayer) to adjust a reserve to show the deferral of taxes  
19 resulting from accelerated depreciation and straight-line depreciation:

20 if the amount allowable as a deduction under this section with respect  
21 to such property (respecting all elections made by the taxpayer under  
22 this section) differs from the amount that would be allowable as a  
23 deduction under section 167 using the method (including the period,  
24 first and last year convention, and salvage value) used to compute  
25 regulated tax expense under clause (i), the taxpayer must make

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<sup>2</sup> The actual USOA account would be the liability account, 281 Accumulated Deferred Income Taxes, but the account is not important for this demonstration.



1 adjustments to a reserve to reflect the deferral of taxes resulting from  
2 such difference.<sup>3</sup>

3 To state it differently, there is no discussion of income in this paragraph, whether that income  
4 is negative or positive. Referring back to my example in JSR-R-1, income tax expense that  
5 is built into MAWC rates is developed using straight line depreciation. To take that a step  
6 further, for the most part, the income tax expense is developed using straight financial  
7 accounting whereas AWW can benefit from many tax exclusions that will lower its taxable  
8 income. So MAWC receives the tax expense in rates whether the company owes income tax  
9 or has an NOL. It is almost like a second deferred tax account.

10 **Q. How could this be viewed as a “second deferred tax account”?**

11 A. Income tax expense is calculated and built into rates as if MAWC is making a given amount  
12 of profit. On one hand the Company receives interest free money (deferred tax expense from  
13 accelerated depreciation) and also receives income tax expense for the allowed profit by the  
14 Commission, yet AWW does not spend it on taxes because of the taxable loss. To also have  
15 the Commission recognize an NOL as a reduction in ADIT would amount to a double  
16 recovery.

17 **Q. How would that be double dipping?**

18 A. The Company states that ADIT should be adjusted downward because it cannot use an NOL.  
19 The double dipping is that: (1) the company did not pay any taxes (NOL) yet it recovered the  
20 income tax expense in rates and then (2) the Company wants ADIT reduced for something it  
21 was compensated for in rates.

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<sup>3</sup> § 168(i)(9)(ii) CFR?

1 **Q. Can you summarize why the NOL should be excluded?**

2 A. The point I'm making is that there was no NOL during the ISRS time period and, even if there  
3 were, the Company cannot assign it to the ISRS calculations because an NOL is not asset  
4 specific.<sup>4</sup> The company argument that excluding the NOL denies it the use of interest free  
5 money is wrong due to the normalization of the ADIT flow back over the life of the asset  
6 regardless of taxable income or loss. The accumulation or dispersion of ADIT is a timing  
7 issue, where as an NOL can be created in one tax year and be used with the next taxable  
8 income. An NOL is not normalized and does not influence Staff's calculation of income tax  
9 expense.

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

11 A. Yes.

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<sup>4</sup> See Case No. WO-2018-0373 At hearing Mr. Wilde was asked the direct question, "An NOL is not attached to any certain infrastructure, any particular asset?" Mr. Wilde answered: "You're correct with that," Tr. Vol. 1, 52:16-18.

**Example of the Normalization of Deferred Income Tax**

10 year regulatory life with 5 year tax depreciation

\$ 100,000.00 Addition to Rate Base

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Depreciation for taxes	20,000.00	20,000.00	20,000.00	20,000.00	20,000.00	0	0	0	0	0
Tax Rate	21%	21%	21%	21%	21%	21%	21%	21%	21%	21%
Deduction in Taxes	4,200.00	4,200.00	4,200.00	4,200.00	4,200.00	0	0	0	0	0
Depreciation for Rates	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00
Tax Rate	21%	21%	21%	21%	21%	21%	21%	21%	21%	21%
Deduction for Rates	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00

	Tax Income	Reg Income	Reg Income	Tax Income
Hypothetical income	100,000.00	100,000.00	100,000.00	100,000.00
tax deduction	20,000.00	10,000.00	(10,000.00)	-
taxable income	80,000.00	90,000.00	90,000.00	100,000.00
	21%	21%	21%	21%
income tax	16,800.00	18,900.00	18,900.00	21,000.00

	Yr 1-5	Yr 6-10
Income Tax Expense	18,900.00	18,900.00
income tax payable	16800	21000
Deferred Income Tax	2100	2100

The Accumulation and Reduction of Deferred Income Tax - Normalization Accounting										
Accumulating Deferred Tax		2,100.00	4,200.00	6,300.00	8,400.00	10,500.00	8,400.00	6,300.00	4,200.00	2,100.00
Annual Add/Reduction	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	(2,100.00)	(2,100.00)	(2,100.00)	(2,100.00)	(2,100.00)
Rate Base Deduction	2,100.00	4,200.00	6,300.00	8,400.00	10,500.00	8,400.00	6,300.00	4,200.00	2,100.00	-