

BACKGROUND

On July 6, 2018, after engaging in discovery and pursuant to the Hearing Officer's Procedural Schedule, the Consumer Advocate filed the pre-filed direct testimony of its expert witness, Mr. Dittmore. Nearly one month later, on August 3, 2018, the Company filed two sets of rebuttal testimony. In one set of testimony, belonging to Mr. John Wilde, TAWC addressed two IRS PLRs² that the Company had provided in discovery and purported to support its position. In the six weeks leading up to the Hearing on the Merits, a time with no filings or additional deadlines except for a pre-hearing status conference, no mention was made of additional PLRs. At the pre-hearing status conference, the Hearing Officer ordered the Consumer Advocate, in the interest of fairness and to avoid trial by ambush, to submit its demonstrative aid to TAWC's counsel by close of business on Monday, September 17, which the Consumer Advocate did.

At approximately 3:30 in the afternoon of Wednesday, September 19, 2018, with the Hearing on the merits set for Friday, September 21, TAWC filed two additional PLRs in the Docket.³ TAWC submitted these late-filed additions as supplements to discovery. While the Consumer Advocate objected to the late-filed information, the Hearing Officer allowed the information to be entered into the record and afforded the Parties an opportunity to offer comments concerning the information after the Hearing. For clarification, the PLRs addressed in these Comments are Letter Nos. 20159021 and 201548017.

² These initial two PLRs were timely submitted through discovery and addressed in pre-filed rebuttal testimony. They are not the same as the latter two PLRs, which are the subject of these Comments.

³ TAWC also included a supplement to Consumer Advocate Request 1-3. This was an anticipated supplement to discovery that, in fact, the Consumer Advocate had pointed out to the Company in good faith to remind the Company of its need to supplement the record. That supplement is not the subject of these Comments.

ANALYSIS

I. THE FACT PATTERNS IN THESE PRIVATE LETTER RULINGS ARE INCONSISTANT WITH THE FACTS IN THIS DOCKET.

In *Letter No. 20159021*, the unidentified taxpayer is a natural gas utility. The issue involves the appropriate level of Net Operating Loss (NOL) to include in base rates within the context of a forecasted test period, which involves the projection of tax losses in a future period. By definition, a base rate case involves the determination of the entire mix of revenue requirement components, including the appropriate balance of Accumulated Deferred Income Tax Liability (ADIT), as well as the related balance (if appropriate) of the NOL (Deferred Asset).⁴

Unlike the facts set out in *Letter No. 20159021*, the facts in TAWC's present case do not involve the projection of a deferred tax liability, nor the projection of future tax losses within the context of a base rate case using a projected test period. Instead, the facts within this Docket involve a situation where base rates, including an NOL asset, have previously been determined and included in rate base. By definition, the Capital Rider surcharges at issue represent a piecemeal calculation of rate base, including what incremental rate base is attributed to the Capital Riders. None of the Company's PLRs reflect the unique circumstances presented by a rider surcharge when an existing NOL balance is already included in base rates, which in turn is more than the NOL asset on the books of the utility at the end of the historical period used to reconcile the surcharge.

In *Letter No. 201548017*, the taxpayer is another unidentified gas utility, which is wholly-owned by its parent. The taxpayer utilizes accelerated tax depreciation, including Bonus Depreciation and has incurred an NOL. The normalization issue arose in the context of a rate case.

⁴ Most utilities net the two components together in arriving at the ADIT Liability balance.

Again, the facts of this PLR are distinguishable because this PLR addresses tax normalization rules in the context of a forward-looking docket, rather than the reconciliation docket which is the subject of TAWC's *Petition*.

Moreover, both PLRs relate to the potential exclusion of a portion of the taxpayer's book NOL asset. This is a very different scenario than TAWC's Capital Riders calculation since the entire balance of TAWC's NOL (and then some) is being recovered in the ratemaking process. TAWC is attempting to impute an NOL asset into the ratemaking calculation where none exists beyond that level already recovered in base rates.

The following table below compares the facts of the current case, Docket No. 18-00022, with the facts contained in the two PLR's:

	TAWC – Docket No. 18-00022	PLR #20159021	PLR #201548017
Type of Utility	Water	Gas	Gas
Is a base rate case involved?	No	Yes	Yes
Is the appropriate level of NOL to be included in <u>base rates</u> being determined?	No	Yes	Yes
Is the projection of tax losses in a future period being determined?	No	Yes.	Yes
Is a rider surcharge involved?	Yes	No	No
Is the exclusion of a portion of the taxpayer's book NOL asset a possibility?	No	Yes	Yes
Does the case involve a Repair Allowance?	Yes	No	No
Is a portion of the NOL proposed to be excluded from the revenue requirement by regulators?	No	Yes	Yes

II. TO THE EXTENT THE PRIVATE LETTER RULINGS DO DISCUSS RELEVANT IRS CODE PROVISIONS, THEY DO NOT SUPPORT TAWC'S NET OPERATING LOSS CALCULATION AND IN FACT SUPPORT THE CONSUMER ADVOCATE'S POSITION.

These PLRs⁵ address the question of whether it is consistent with the IRS Code to exclude some portion of the projected NOL asset when computing a forward-looking rate base. The Consumer Advocate is not proposing to exclude any portion of the NOL asset within the calculation of Capital Riders rate base and has provided evidence that the NOL asset currently recovered from ratepayers in base rates is more than the current balance of the NOL asset.⁶ Questions concerning normalization violations involve the alleged denial of deferred tax assets in rate base associated with depreciation related book/tax timing differences. Therefore, this Docket is not about exclusion of an NOL asset because no exclusion of the NOL has been offered by the Consumer Advocate. Instead, the issue suggested by TAWC is whether a hypothetical NOL asset must be imputed into the Capital Riders portion of rate base. It should not.

The taxpayers⁷ requested the IRS to rule that:

1. It would be a normalization violation to fail to reduce the ADIT liability balance for the balance of the NOL based upon the facts above. As discussed below, the Company is recovering a NOL balance in base rates currently that is greater than its actual NOL asset balance at December 31, 2017.
2. With respect to Ruling 1, the use of the balance of the taxpayers' NOL balance that is less than the amount attributable to Accelerated Depreciation computed on a "with and without" basis would be a normalization violation.

⁵ For purposes of this section, as both letters cite the same IRS code sections, the letters can be combined into the same discussion.

⁶ See Dittmore Demonstrative Aid, slide 4.

⁷ The two PLR's are similar in nature, with the exception that PLR 20158017 also references the position of regulators that an exclusion of Income Tax Expense to reflect the benefits of the NOLC is advocated. This position is not at all relevant to the position of the Consumer Advocate, therefore it is not further discussed in this document.

TAWC's ADIT liability, as recorded on the Company's books, will necessarily reflect the difference between the actual tax deductions taken on the tax return compared with the corresponding book deductions. Therefore, the tax deductions actually taken on the tax return, including the NOL, are reflected in the ADIT liability balance. The evidence in this case demonstrates the significant increase in net ADIT liability balance occurring over the four-year period the Capital Riders have been in effect.⁸

Further, evidence in this case indicates that over the four-year period of the Capital Riders, TAWC had positive taxable income.⁹ This evidence is consistent with the fact that the NOL balance has actually declined from that included in base rates.¹⁰ Thus, despite the utilization of Bonus Depreciation and the Repair Allowance, TAWC still had positive taxable income over this period, and thus the NOL asset balance has declined. This is also borne out by the comparison of the book value of the NOL at these two points in time. The positive taxable income over this period results in a reduction in the NOL asset as demonstrated in the Company's own discovery responses, which illustrates the decline in the NOL balance over this four-year period.¹¹ This declining asset balance incorporates the actual tax depreciation methods utilized by TAWC.

Importantly, the *Letter No. 20158017* includes the following reference: "Taxpayer for normalization purposes calculates the portion of the Net Operating Loss Carryforward (NOLC) attributable to Accelerated Depreciation using a "last dollars deducted" methodology, meaning that an NOLC is attributable to Accelerated Depreciation only to the extent of whichever item is lesser – the Accelerated Depreciation or the NOLC."¹² In TAWC's current situation, the NOLC is less than the timing differences associated with book and tax depreciation; therefore, it is

⁸ See Dittmore Demonstrative Aid, slide 3.

⁹ See Dittmore Testimony, page 13 (sourced from the TAWC Confidential Responses to CPAD 1-2 and 3-16).

¹⁰ See Dittmore Demonstrative Aid, slide 4.

¹¹ See TAWC Confidential Responses to CPAD 1-2 and 3-16.

¹² *Letter No. 20158017*, page 1 (August 19, 2015).

necessary to ensure the entire balance of TAWC's NOL is recovered in its revenue requirement to meet the stated requirement in *Letter No. 20158017*.

The TAWC revenue requirement is comprised of two recovery mechanisms: base rates and the Capital Riders surcharge. Therefore, the implications of what the Company currently recovers in each mechanism must be considered to evaluate compliance with normalization requirements. This normalization requirement is met within the Consumer Advocate position as the NOL recovered in base rates exceeds the actual NOL balance at the end of the Capital Riders reconciliation period, proving the Company's entire NOL balance is being recovered in the revenue requirement. Therefore, the Consumer Advocate's treatment of the NOL is consistent with the gas utility taxpayer's NOL determination described above.

The PLRs include several IRS Code Section references, which are identified in the following text along with a description of how the Consumer Advocate's recommendations either comply with, or are not inconsistent with, the listed requirements.

Section 168(i)(9)(A)(i) and (ii)¹⁴ – This section requires the use of a depreciation method for purposes of computing income tax expense to be no shorter than the period used to develop depreciation rates incorporated into the calculation of Depreciation Expense for ratemaking purposes (part i). Also, this section requires the consistent treatment of tax expense, depreciation expense and ADIT within the ratemaking calculation as it relates to book/tax depreciation differences. This requirement is met as the Consumer Advocate has not modified the TAWC Depreciation Expense rates used in either computing Depreciation Expense or the appropriate deduction for depreciation within the calculation of Income Tax Expense.

¹⁴ 26 IRC § 168, pages 688-689 (available at <https://www.gpo.gov/fdsys/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleA-chap1-subchapB-partVI-sec168.pdf>).

Section 168(i)(9)(B)(i) and (ii)¹⁵ – The referenced Code above will not be met if a procedure or adjustment is used for ratemaking that is inconsistent with the above-listed requirements. Subsection (ii) indicates that such inconsistent procedures would include the estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to rate base. The Consumer Advocate's position meets this requirement in two ways. First, the items listed above are historic in nature and therefore do not contain estimates or projections. Secondly, all three items are properly synchronized within the Consumer Advocate's position. The Consumer Advocate's tax expense calculation normalizes depreciation, reflects the ADIT Liability balance based upon the calculation of such book tax timing differences associated with the Capital Rider Plant, and properly considered whether there was any incremental Net Operating Loss generated in the period, inclusive of the actual Bonus Depreciation and Repair Allowance deductions. Further, the Consumer Advocate's components are computed consistent with the method used within the Company's ratemaking calculation.

In fact, such items are not properly synchronized within the TAWC proposal and therefore the Company's proposal does not meet this requirement. The Deferred Tax Liability balance computed by the Company for purposes of determining its Capital Rider rate base relies exclusively upon the use of MACRS tax depreciation and excludes Bonus Depreciation and the Repair Allowance, despite the fact these deductions are incorporated in the Company's tax return and used in the calculation of its book balance of Accumulated Deferred Income Tax liability. Therefore, the Company has used a differing methodology for book purposes than it has used within the Capital Rider revenue requirement calculation.¹⁶

¹⁵ *Id.* at page 689.

¹⁶ See Dittmore Testimony, page 3, lines 6-11.

Section 1.167(l)-1(h)(1)(i)¹⁷ – This section provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. This is another example where the Consumer Advocate's position meets this requirement, but the Company's proposal does not. The Consumer Advocate properly identifies the ADIT liability because it relies upon the actual tax methods used for determining tax depreciation and then compares this result with book depreciation to arrive at the ADIT balance. However, the Company's ADIT balance incorporated within the Capital Riders is not calculated using the tax depreciation methods used on its tax return. Simply, the Company ignores the reality that it utilizes Bonus Depreciation and the Repair Allowance on its return, but fails to use the resulting balances in the calculation of its ADIT balance.

Section 1.167(l)-1(h)(1)(iii)¹⁸ – This section in the PLR contains the following language:

the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then that amount and time of the deferral of tax liability shall be taken into account in such appropriate time an manner as is satisfactory to the district director.

Again, the Consumer Advocate meets this requirement by its reliance upon the actual tax depreciation methods taken by the Company on its tax return. The Company fails this requirement

¹⁷ 26 CFR Ch. I, § 1.167(l)-1, page 483 (*available at* <https://www.gpo.gov/fdsys/pkg/CFR-2018-title26-vol3/pdf/CFR-2018-title26-vol3-sec1-167l-1.pdf>)

¹⁸ *Id.* at pages 483-484.

by failing to reflect in its calculation of the ADIT balance for Capital Riders purposes, which should be the actual tax depreciation methods used in its tax return.

This section requires that the effects of an NOLC must be taken into account for normalization purposes. The IRS has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from rate base to which the taxpayer's rate of return is applied, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. The PLR continues by stating that the portion of an NOLC is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes.

The Consumer Advocate has met this requirement because it has not proposed the elimination of any portion of the Company's NOL asset. The IRS requirement indicates that to the extent an NOL exists, it must be first attributed to accelerated tax depreciation. Since the NOL balance at year end, \$1.7 million¹⁹, is less than the NOL balance currently recovered in the TAWC revenue requirement of \$1.8 million, there is no further consideration or attribution of an NOL required. The full NOL asset is recovered in the TAWC revenue requirement. There is no adjustment made by the Consumer Advocate to deny any portion of the NOL asset from recovery. Simply, there is nothing in this PLR which requires the inclusion of an NOL asset in rate base which exceeds the actual NOL balance at the end of the historic period under review.

Section 1.167(1)-1(h)(2)(i)²⁰ – This section provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve

¹⁹ See Dittmore Demonstrative Aid, slide 4.

²⁰ *Id.* at page 484.

account. The Consumer Advocate's position meets this requirement by including the deferred tax liability associated with Capital Rider investment within the ADIT balance of the Capital Riders revenue requirement.

Section 1.167(1)-(h)(6)(i)²¹ – This section provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from rate base exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayers' expense in computing cost of service in such ratemaking.

The ADIT balance proposed by the Consumer Advocate within the Capital Rider revenue requirement is (\$8.9) million.²² When added to the ADIT balance in the most recent rate case, (\$26.7)²³ million, the total amount of ADIT offsetting the TAWC revenue requirement is \$36.6 million, which is substantially less than the actual TAWC balance of ADIT at December 31, 2017 (\$42.6) million. The year-end balance of ADIT is inclusive of the NOL asset. Therefore, this normalization requirement is met as the total rate base deduction underlying the TAWC revenue requirement (base rates plus the Capital Riders) is substantially less than the actual TAWC ADIT balance.

Section 1.167(1)-(h)(6)(ii)²⁴ – This section provides that for the purpose of determining the maximum amount of the reserve to be excluded from the rate base under subdivision (i) above, if solely an historical period is used to in determining the depreciation for federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve at the end of the historical period.

²¹ *Id.* at pages 487-488.

²² Exhibit DND-2

²³ Exhibit DND-4 and Dittemore Demonstrative Exhibit, slide 3.

²⁴ *Id.* at 488.

The reality, as described above, is that the Consumer Advocate's position includes less than the actual book level of ADIT within the revenue requirement of TAWC and, therefore, is in fact more conservative than the requirement above. This IRS requirement is designed to ensure that an appropriate level of NOL asset is included in rate base. Rather than the rate base offset in this case (ADIT offset) exceeding the actual ADIT balance, including the NOL asset, the Consumer Advocate's position results in a rate base offset that is less than the historical ADIT balance at the end of the reconciliation period.²⁵

Section 1.167(l)-1(h)²⁶ – This section requires taxpayers to maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. This requirement is met because TAWC maintains such a reserve on its books. It is important to understand, however, that this reserve requirement was not met by TAWC for purposes of computing the reserve associated with the Capital Riders as it ignored key components of its tax depreciation methods.

The code references contained in both PLRs and a brief description of how the Consumer Advocate's position complies with the Code Sections are summarized below:

Code Section	Does the Consumer Advocate's position conform to the IRS PLRs?	Brief Reasoning
Section 1.167(1)-1(a)(1)	Yes	This section indicates that questions of normalization are limited to those related to deferral of federal income taxes related to depreciation. The Consumer Advocate's position meets this requirement as it is not flowing-through the impact of bonus depreciation within its calculation of income tax expense either in the base rate case, nor the Capital Rider case.
Sections 168(i)(9)(A)(i) and (ii)	Yes	The Consumer Advocate's position meets this requirement by not modifying the TAWC Depreciation Expense rates. The depreciation rates

²⁵ *Ibid.*

²⁶ *Id.* at page 483.

		used to compute income tax expense are the book rates of TAWC. Also, the Consumer Advocate's position has properly synchronized tax expense, depreciation expense and the ADIT. The Company's position does not meet this standard by failing to properly reflect the ADIT balance that reflect what tax deductions are actually taken on their tax return.
Section 168(i)(9)(B)(i)-(ii)	Yes	The Consumer Advocate's position properly synchronizes the determination of ADIT, depreciation expense and tax expense by using consistent methodologies. The TAWC proposal does not properly synchronize these elements by failing to consider actual tax depreciation methodologies within its ADIT calculation.
Section 1.167(l)-1(h)(1)(i)	Yes	This section requires that the reserve should reflect the total amount of the deferral of federal tax liability resulting from the use of differing depreciation methods for tax and ratemaking purposes. The Consumer Advocate's position meets this requirement using the last dollars deducted methodology described in PLR 201548017.
Section 1.167(l)-1(h)(1)(iii)	Yes	The Consumer Advocate's position meets this requirement by its reliance upon the actual tax depreciation methods taken by the Company on its tax return.
Section 1.167(1)-1(h)(2)(i)	Yes	The Consumer Advocate's position meets this requirement by including the deferred tax liability associated with Capital Rider investment within the ADIT balance of the Rider revenue requirement.
Section 1.167(1)-1(h)(6)(i)	Yes	The Consumer Advocate's position meets this requirement, since in its total rate base deduction underlying the TAWC revenue requirement (base rates plus the capital riders) is substantially less than the actual TAWC ADIT balance.
Section 1.167(1)-1(h)(6)(ii)	Yes	The Consumer Advocate's position meets this requirement because it results in a rate base offset that is <u>less than</u> the historical ADIT balance at the end of the reconciliation period. The Consumer Advocate's position meets the requirement by ensuring the ratemaking recovery of the historic level of NOLC. This section indicates that if a historical period is used the reserve (inclusive of the NOLC) should be stated based upon historic period balances. ²⁷ The Company's proposal does

²⁷ See PLR 20158017, page 3.

	not meet this requirement because it ignores the historic NOL balance of TAWC.
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CONCLUSION

For the foregoing reasons, the Consumer Advocate respectfully requests that the Commission view TAWC's late-filed PLRs in the context provided above and taking into account the Consumer Advocate's position, which is in the public interest and will result in just and reasonable rates.

RESPECTFULLY SUBMITTED,



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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served via U.S. Mail or electronic mail upon:

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This, the 1st day of October, 2018.



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