BEFORE THE TENNESSEE PUBLIC UTILITY COMMISSION

NASHVILLE, TENNESSEE

March 6, 2019

IN RE:	)	
	)	
PETITION OF TENNESSEE-AMERICAN WATER COMPANY IN SUPPORT OF THE CALCULATION OF THE 2017 CAPITAL RECOVERY RIDERS RECONCILIATION	))))	**DOCKET NO. 18-00022**

ORDER GRANTING *PETITION* AS AMENDED

This matter came before Chair Robin L. Morrison, Vice Chair Kenneth C. Hill and Commissioner David F. Jones of the Tennessee Public Utility Commission (the "Commission" or "TPUC"), the voting panel assigned to this docket, during a regularly scheduled Commission Conference held on December 17, 2018, to consider the *Petition in Support of the Calculation of the 2018 Capital Recovery Riders Reconciliation* ("*Petition*") filed on March 2, 2018 by Tennessee-American Water Company ("TAWC," "Tennessee-American" or the "Company").

BACKGROUND AND *PETITION*

TAWC filed and gained approval to implement a Qualified Infrastructure Investment Program ("QIIP") Rider, Economic Development Investment ("EDI") Rider, Safety and Environmental Compliance ("SEC") Rider (collectively "Investment Riders" or "Capital Riders") and a Pass-Through Mechanism for Purchased Power, Chemicals, Purchased Water, and Wheeling Water in TPUC Docket No. 13-00130.[1] In accordance with its tariff, TAWC is required to submit a reconciliation of the Capital Riders no later than March 1st of every year.

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[1] *See In re: Petition of Tennessee-American Water Company for Approval of a Qualified Infrastructure Investment Program, an Economic Development Investment Rider, a Safety and Environmental Compliance Rider and Pass-Throughs for Purchased Power, Chemicals, Purchased Water, Wheeling Water Costs, Waste Disposal and TRA Inspection Fee*, Docket No. 13-00130, *Order Approving Amended Petition* (January 27, 2016).

On March 2, 2018, the Company filed the *Petition*. On March 23, 2018, the Consumer Protection and Advocate Division of the Office of the Tennessee Attorney General ("CPAD" or "Consumer Advocate") filed a *Petition to Intervene*, which was granted by the Hearing Officer in an Order dated April 11, 2018. On July 2, 2018, the Hearing Officer issued an *Order Establishing a Procedural Schedule* and the parties engaged in discovery pursuant to that schedule. In its *Petition*, TAWC seeks approval of the 2018 Reconciliation of the Capital Riders to reflect the net under-recovery of capital expenditures for the 2017 period.

<u>POSITIONS OF THE PARTIES</u>

TAWC's *Petition*

Tennessee-American's *Petition*, as filed, proposed an additional QIIP surcharge of 2.484% resulting in revenue recovery of $876,859; an EDI surcharge of -0.053% resulting in a revenue recovery of ($18,855); and an SEC surcharge of -0.059% resulting in a revenue recovery of ($20,773).[2] However, the Company's calculations underwent a series of amendments during the course of discovery with the Consumer Advocate. Prior to the hearing on the *Petition*, the Company sought a QIIP surcharge of 2.718% resulting in revenue recovery of $959,555; an EDI surcharge of -0.045% resulting in a revenue recovery of ($15,865); and an SEC surcharge of -0.0121% resulting in a revenue recovery of $42,818.[3]

In Pre-filed Testimony submitted with the *Petition*, Ms. Linda C. Bridwell states that the Capital Riders reduce the need for rate cases, support essential improvements in the infrastructure, reduce the rate shock to customers, support economic growth and job creation, and promote safe and reliable water service. Additionally, the Capital Riders allow the Company

[2] Linda C. Bridwell, Pre-filed Direct Testimony, pp. 34-35; Exhibit LCB (March 2, 2018).
[3] *Tennessee-American Water Company's Final Revised Exhbits, Schedules and Workpapers, TAW_2017_Capital_Rider_Recon,* page 4 of 209 (September 17, 2018).

to make timely investments while maintaining a fair rate of return.[4] Ms. Bridwell also states that no changes in market conditions or other factors have affected this public interest status.[5] For these reasons, Ms. Bridwell concludes the Capital Riders remain in the public interest.

Ms. Bridwell attests the *Petition* is made to reconcile the investment period of calendar year 2017 and incorporates the adjustments and corrections ordered in TPUC Docket Nos. 15-00111, 16-00022 and 17-00020.[6] According to Ms. Bridwell, the Company used the authorized cost of capital, depreciation rates, property tax rate, and annual revenues from its last rate case in TPUC Docket No. 12-00049.[7] The Company indicates it has not included any operating expenses for the EDI or SEC riders in the *Petition*.[8] Ms. Bridwell testifies the *Petition* includes all of the information required by the Company's tariffs and is consistent with the information provided in previously approved petitions.[9]

An earnings test adjustment provides oversight to ensure the Company does not exceed its authorized rate of return ("ROR"). According to the *Petition*, Tennessee-American exceeded its authorized 7.23% ROR. The Company calculated that the amount of over-earnings required a $185,720 reduction to the reconciliation of revenues.[10] This amount is included in the determination of the surcharges and obviously has the effect of reducing the amount of surcharge revenues needed to cover the revenue requirement resulting from the aforementioned riders. The Company made subsequent corrections and changes to this calculation and others in the initial *Petition*. In response to discovery requests of the Consumer Advocate, TAWC arrived at the

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[4] Linda C. Bridwell, Pre-filed Direct Testimony, p. 15 (March 2, 2018).
[5] *Id.* at 38.
[6] *Id.* at 3-4.
[7] *Id.* at 22-25.
[8] *Id.* at 17.
[9] *Id.* at 4.
[10] *Id.* at 30; Exhibit LCB.

conclusion it had not over-earned during the 2017 period. However, this calculation was amended again prior to the hearing and a $39,728 reduction was proposed.[11]

Company witness, Brent O'Neill, provided a discussion in his Pre-filed Testimony of the capital expenditures included for recovery in the *Petition*. Mr. O'Neill testified the data used to prepare his exhibits were taken from the books and records of the Company, the officers and associates of the Company and other internal sources examined by him.[12] Major capital projects are developed from the Comprehensive Planning Study, which identifies necessary projects in order to maintain safe, dependable and reliable water service.[13]

Mr. O'Neill discussed how the Company monitors the construction budget. Tennessee-American utilizes a regional Capital Investment Management Committee ("CIMC" or "Committee") consisting of the Company President, Operations Manager, Engineering Project Manager, Financial Analyst, and Operations Specialist to establish capital budgets and review expenditures compared to budgets. Any necessary changes are reviewed by the CIMC, and movement of budget funds from one project to another is approved by the Committee.[14] To provide an added level of coordination, a Functional Sign-Off ("FSO") Committee signs off on projects and reviews spending.

Use of both of these Committees allows Tennessee-American to immediately address projections in spending. These Committees also review investment projects from inception to completion to ensure the projects meet the business need for expenditure and usefulness.[15] Procurement activities are completed through a bid solicitation process. American Water Works

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[11] *Tennessee-American Water Company's Final Revised Exhbits, Schedules and Workpapers, TAW_2017_Capital_Rider_Recon,* p. 4 of 209 (September 17, 2018).
[12] Brent E. O'Neill, Pre-filed Direct Testimony, pp. 2-3 (March 2, 2018).
[13] *Id.* at 4-5.
[14] *Id.* at 5-6, 19.
[15] *Id.* at 5-6.

takes competitive bids for necessary materials and supplies, and the Company has the advantage of purchasing these items on an as needed basis.[16]

For 2017, Tennessee-American overspent its capital budget in total by $1,601,421 or 10%.[17] Mr. O'Neill described a delay in the Tennessee River Transmission Project under the QIIP as attributable to permitting requirements and clarifications required by the Tennessee Valley Authority.[18] As a result of the project delay, other projects slated from 2018 were pulled forward and addressed under the SEC Rider rather than the QIIP Rider.[19] Other variances included "unexpected challenges" in main replacement projects, reductions in reimbursements paid by the Tennessee Department of Transportation, main breaks, and unexpected water tank rehabilitation.[20]

Consumer Advocate's Direct Testimony

After reviewing the *Petition* and supporting documentation, the Consumer Advocate alleges the following two issues require that adjustments be made to the Company's filing.

1. The accumulated deferred income taxes ("ADIT") were significantly undervalued, resulting in an inflated Rate Base and revenue requirement which leads to unwarranted, higher rates.[21]

2. The earnings test calculation is not consistent with the portion of the Stipulation and Agreement in Docket No. 12-00049 that eliminates incentive compensation costs from the Commission-approved revenue requirement.[22]

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[16] *Id.* at 6.
[17] *Id.* at 9.
[18] *Id.*
[19] *Id.* at 10-12.
[20] *Id.* at 13-15.
[21] David Dittemore, Pre-filed Direct Testimony, pp. 2-3 (July 6, 2018).
[22] *Id.* at 19-20.

The result of these adjustments reduces the Capital Riders by $167,330 instead of increasing them by $837,231 as proposed by the Company, a difference of $1,004,561. The reconciliation percentage would change to -0.474% instead of the requested 2.372%.[23]

According to Mr. Dittemore, the Company has been inconsistent with the application of the bonus depreciation and the repair allowance for this filing in comparison with these same items on the tax returns of the Company. Mr. Dittemore indicates that the Company did not include either bonus depreciation or the repair allowance in calculating its tax depreciation rates in this docket while both were claimed as deductions.[24] Bonus depreciation allows the taxpayer to deduct fifty percent of the costs of capital expenditures in the year the expenditure occurred, and the repairs allowance allows for a 100% deduction for certain qualifying expenditures, resulting in sizable tax benefits. Mr. Dittemore maintains that his proposed adjustment is "necessary to match the tax depreciation methodology" of the Capital Riders calculation to that of the Company's tax return, and he claims the proposed adjustment is consistent with the Company's Capital Riders tariff.

Mr. Dittemore proposes an ADIT balance of $8,931,682 as opposed to the Company's amount of $616,849.[25] While the Consumer Advocate acknowledges that Tennessee-American has historically used the same methodology as that applied in this docket, Mr. Dittemore recommends the Commission reject the Company's proposal.[26] To better illustrate the overall impact of an understated ADIT balance, Mr. Dittemore compares the approved rate base data from the last rate case with the proposed Capital Rider rate base. The result of these comparisons indicates to Mr. Dittemore that ratepayers are paying "unjust and unreasonable"

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[23] *Id.* at 2-4.
[24] *Id.* at 6.
[25] *Id.* at 4-5.
[26] David Dittemore, Pre-Filed Direct Testimony, pp. 4-6 (July 6, 2018).

rates for a return on a hypothetical rate base that exceeds the Company's actual rate base.[27] Even with the Consumer Advocate's proposed adjustment of $8.2 million, Mr. Dittemore notes that there is approximately $7 million in growth that is not related to Capital Rider expenditures.[28]

As most of the ADIT is plant related, Mr. Dittemore submitted that a comparison of overall ADIT balance as a percentage of the gross investment is an additional measurement of reasonableness. Mr. Dittemore compared the ADIT balance reported by the Company in the Capital Riders Reconciliation to the gross plant in the riders which results in a ratio of 1.22%. The total Company actual ADIT was then compared to the total gross plant, and the result was a ratio of ADIT to gross investment of 14.14%. This is more than ten times the ratio for the Capital Riders, and Mr. Dittemore submits the results indicate that the Capital Riders' ADIT balance is not reasonable.[29]

Additionally, Mr. Dittemore compared the Capital Riders' qualifying capital expenditures with the total capital expenditures and concludes the ADIT balance has grown by $15.25 million since the last rate case and that the Capital Riders' investment has a greater impact on the ADIT balance than the non-Capital Riders' expenditures. Mr. Dittemore concludes that ignoring the bonus depreciation and the repair allowance in the ADIT calculation is unreasonable.[30]

With respect to the Company's results of the Earnings Test in response to a Consumer Advocate data request, Mr. Dittemore takes no position on the accuracy of this data, but contends that the Company did not adjust its operating income as specified in the last rate case in TPUC Docket No. 12-00049 regarding incentive compensation. A footnote in the Settlement Agreement in Docket No. 12-00049 supports the exclusion of 50% of short-term incentive

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[27] *Id.* at 19.
[28] *Id.* at 16.
[29] *Id.* at 17.
[30] *Id.* at 18-19.

compensation and 100% of long term incentive compensation. Mr. Dittemore proposes that the Company modify the Earnings Test calculation consistent with the Order in the last rate case and approved methodologies. This necessary adjustment would result in excess earnings of $356,149 (see Exhibit DND-5).[31]

Tennessee-American Rebuttal Testimony

1. **Bonus Depreciation and Repair Deductions**

With respect to the Consumer Advocate's proposed adjustment to the balance of ADIT related to bonus depreciation and repair deductions, Ms. Bridwell explains the current surcharge calculation for ADIT compares book depreciation to Modified Accelerated Cost Recovery System ("MACRS") depreciation. The Company avers that including the difference between book depreciation and MACRS depreciation in the Capital Riders is a sound regulatory approach consistent with capital recovery rider calculations first used in 2013.[32] This method is far simpler than using bonus depreciation and repair deductions which are far more complex. Further, book vs. MACRS is usually not large enough to create a Net Operating Loss ("NOL"), whereas the inclusion of bonus depreciation and repair deductions can generate an NOL, complicate the tax calculation, and creates a risk of normalization violations. The Company contends Mr. Dittemore erred by not considering an NOL in his calculations and refers to the testimony of Mr. Wilde to explain the tax normalization violation issues.[33]

The Company contends the exclusion of bonus depreciation and repairs allowance provides a more streamlined regulatory mechanism. Ms. Bridwell, however, states that should the Commission adopt the recommendation of the Consumer Advocate and include bonus

[31] David Dittemore, Pre-Filed Direct Testimony, pp. 19-21 (July 6, 2018).
[32] Linda C. Bridwell, Pre-filed Rebuttal Testimony, p. 3 (August 3, 2018).
[33] *Id.* at 3-4.

depreciation and repair deduction, then a calculation of the NOL should also be included in the capital recovery riders' calculations to avoid a tax normalization violation.

In Pre-filed Rebuttal Testimony on behalf of the Company, Mr. John Wilde describes rules regarding bonus depreciation and repairs for income tax purposes. Mr. Wilde is the vice president of tax for American Water Works and its affiliates, such as the Company. Mr. Wilde asserts that if bonus depreciation is utilized in the calculations in the docket, then the tax basis of the property changes for MACRS depreciation deductions.[34] He claims the repair deduction is far more complicated and requires a detailed analysis of the circumstances of each individual project.

If permanent improvements better the unit of property or adapt it to a new or different use, the repair is capitalized and is deducted through depreciation or amortization, if it does not, it is deducted as a repair.[35] Any deferred taxes resulting from accelerated or bonus depreciation are subject to tax normalization rules and any income taxes that result from using a normalization method of accounting are included as a reduction to rate base.[36] Further, Mr. Wilde states that if bonus depreciation and repairs are large enough to result in the Company incurring a loss, that loss is recorded as a deferred asset representing the future value of the usage of that loss. In other words, the Company has not yet received the use of the zero cost of capital.[37]

Mr. Wilde argues it would be improper to include the accelerated savings as a deduction to rate base if this savings resulted in a loss because the Company has not received the benefit from the tax savings. Moreover, he asserts the tax normalization rules require the rate base

[34] John R. Wilde, Pre-filed Rebuttal Testimony, pp. 3-4 (August 3, 2018).
[35] *Id.* at 4-5.
[36] *Id.* at 4-7.
[37] *Id.* at 7.

reduction to be reduced by the amounts of the NOL, and should the Company be found in violation of the tax normalization rules it would be prohibited from using accelerated depreciation in the future.[38]

Mr. Wilde avers the ADIT liability for 2017, including bonus depreciation and repairs, is $1,254,176 rather than $8.9 million as proposed by the Consumer Advocate.[39] The Company disagrees with the Consumer Advocate's claim that the Company's NOL is hypothetical because TAWC has taxable income during the 2014–2017 period. The Company claims it is carrying forward an NOL generated from taking accelerated tax depreciation, bonus depreciation and a repair deduction going back to 2008.[40] Mr. Wilde points out the Company provided the Consumer Advocate in discovery with information he contended demonstrated that 2014–2017 Capital Rider inclusion of bonus depreciation and repair deductions incrementally produces additional NOL for the 2014–2017 timeframe.[41]

A consolidated NOL carryforward has had net cumulative losses since 2008, thus requiring a deferred tax account. The Company relies upon Private Letter Rulings issued by the Internal Revenue Service ("IRS") at the request of other utilities that have been provided that state it is a normalization violation if an NOL related to accelerated tax depreciation (inclusive of bonus depreciation) is not excluded from rate base.[42] Mr. Wilde agrees with Ms. Bridwell that if the Commission approves bonus depreciation and repairs for inclusion in the 2017 Capital Rider reconciliation, then the associated NOL should also be included.[43]

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[38] *Id.* at 7-8.
[39] *Id.* at 5.
[40] *Id.* at 9.
[41] *Id.*
[42] *Id.* at 8-10.
[43] *Id.* at 10.

2. The Earnings Test

The Company opposes the adjustment proposed by the Consumer Advocate. The Consumer Advocate's modification to the earnings test includes a reduction of $650,869 to actual 2017 attained earnings, consisting of a $389,651 imputation for annual performance pay and a $261,218 imputation for long-term performance pay. Ms. Bridwell testifies that the recommended revisions of the Consumer Advocate to remove both annual and long-term performance pay for both the Company and affiliated support services from the actual attained earnings test are overstated and require corrections.[44]

According to Ms. Bridwell, there is no evidence in the Settlement Agreement that resolved TPUC Docket No. 12-00049 that the $440,000 as proposed by the Consumer Advocate was excluded from the calculation of the revenue requirement in setting base rates. She agrees that the Settlement Agreement value for salaries and wages of $5,188,473 (which did include an Incentive Pay Plan exclusion of $115,793)[45] does tie to the expense level proposed by the Consumer Advocate. In the schedules attached to the Settlement Agreement, however, the amount of support services is $5,430,920, which is not tied to the Consumer Advocate's proposal of $4,825,406.

As stated by Ms. Bridwell, this exemplifies that the Consumer Advocate's support services position was not agreed to by all parties and was not adopted by the Commission. Further, while the testimony in Commission Docket No. 12-00049 mentions an exclusion of 50% of annual performance pay from support services, it does not mention a proposed exclusion of long-term

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[44] Linda C. Bridwell, Pre-filed Rebuttal Testimony, p. 7 (August 3, 2018).

[45] This exclusion included 50% of TAWC's annual local labor performance plan and 100% exclusion of TAWC's annual long-term performance plan.

performance pay. The adjustments made by the Consumer Advocate should be to earnings, not expense. Also, the adjustments would need to include tax effects.[46]

In sum, Tennessee-American asserts the plain language of the tariff should be followed as it has been applied since 2013, and no revision should be made to the 2017 earnings that would result in an additional $127,917 being added to the earnings test adjustment.[47] Ms. Bridwell attests that even if the Company earns above its authorized return, it does not mean the true-up set forth in the capital recovery riders tariff should be disregarded as the Consumer Advocate suggests. She states that the Company discovered an error in its response to the Consumer Advocate's Fourth Discovery Request and after correcting the error, the Company has an earned return of 7.25% equating to earnings of $39,728 above its authorized return of 7.23%.[48]

THE HEARING

The Hearing on the *Petition* was held before the voting panel assigned to this docket on September 21, 2018, as noticed by the Commission on September 11, 2018. Participating in the Hearing were:

> Tennessee-American Water Company – Melvin J. Malone, Esq., Butler Snow LLP, 150 3rd Avenue South, Suite 1600, Nashville, Tennessee 37201.
>
> Consumer Protection and Advocate Division – Daniel P. Whitaker, III. Esq. and Vance Broemel, Post Office Box 20207, Nashville, Tennessee 37202-4015.

Mr. Brent O'Neill, John R. Wilde, and Linda Bridwell provided testimony on behalf of the Company and were subject to cross-examination. Mr. David Dittemore provided testimony on behalf of the Consumer Advocate and was subject to cross examination. Members of the public were given an opportunity to offer comments, but no one sought recognition to do so.

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[46] Linda C. Bridwell, Pre-filed Rebuttal Testimony, pp. 7-10 (August 3, 2018).
[47] *Id.* at 10.
[48] *Id.* at 11-12.

STANDARD FOR COMMISSION APPROVAL

Tenn. Code Ann. § 65-5-103(d)(5) states:

> (A) A public utility may request and the commission may authorize a mechanism to recover the operational expenses, capital costs or both related to other programs that are in the public interest.
>
> (B) A utility may request and the commission may authorize a mechanism to allow for and permit a more timely adjustment of rates resulting from changes in essential, nondiscretionary expenses, such as fuel and power and chemical expenses.
>
> (C) Upon a finding that such programs are in the public interest, the commission shall grant recovery and shall authorize a separate recovery mechanism or adjust rates to recover operational expenses, capital costs or both associated with the investment in other programs, including the rate of return approved by the commission at the public utility's most recent general rate case pursuant to § 65-5-101 and subsection (a).

FINDINGS AND CONCLUSIONS

After the hearing and upon consideration of the pleadings, Pre-filed Testimony, and the entire administrative record, the panel found the following with respect to the two major issues presented in the docket:

First, based upon the evidentiary record in this proceeding the hearing panel concluded that Tennessee-American should file revised calculations to include bonus depreciation and the repairs deduction, while also recognizing the Net Operating Loss carryforward of $4,938,170. While the Consumer Advocate contested whether there is an NOL applicable here, there is evidence in the record to support a finding the Company has incurred an NOL. Furthermore, as the Net Operating Loss carryforward presented by the Company is based, in part, on an estimate of 2017 losses, the hearing panel concluded it must be trued-up to actual 2017 results.

Second, consistent with the methodologies approved in TPUC Docket No. 13-00130, the panel concluded that the Company has properly accounted for incentive pay compensation within its earnings test in this *Petition*. Prospectively, however, the panel unanimously concluded that excluding 100% of incentive pay for Tennessee-American's Services Support Company in subsequent earnings tests is in the public interest and also consistent with the Commission's long-standing policy regarding incentive pay exclusion. The hearing panel voted unanimously to direct Tennessee-American to exclude 100% of incentive pay for Tennessee-American's Services Support Company in subsequent earnings tests submitted with reconciliation filings.

Based on the evidentiary record, the panel voted unanimously to adopt the following corrected surcharges:

1. A QIIP Rider surcharge of 2.615%;
2. An EDI Rider surcharge of -0.049%; and
3. A SEC Rider surcharge of 0.042%.

These amounts represent a total surcharge of 2.608%. Finally, in conjunction with approval of these surcharges, the panel required Tennessee-American to submit tariff provisions consistent with its decision.

IT IS THEREFORE ORDERED THAT:

1. The *Petition in Support of the Calculation of the 2018 Capital Riders Reconciliation* filed on March 2, 2018, by Tennessee-American Water Company requesting Commission approval of its Calculation of the 2018 Capital Riders Reconciliation is granted, subject to the corrections set forth above.

2. The corrected Capital Rider surcharges are adopted as follows:

   - A Qualified Infrastructure Investment Rider surcharge of 2.615%;
   - An Economic Development Investment Rider surcharge of -0.049%; and

- A Safety and Environmental Compliance Rider surcharge of 0.042%.

These amounts represent a total surcharge of 2.608%.

3. Any person who is aggrieved by the Commission's decision in this matter may file a Petition for Reconsideration with the Commission within fifteen (15) days from the date of this Order.

4. Any person who is aggrieved by the Commission's decision in this matter has the right to judicial review by filing a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty (60) days from the date of this Order.

Chair Robin L. Morrison, Vice Chair Kenneth C. Hill, and Commissioner David F. Jones concur.

ATTEST:

Earl Taylor

Earl R. Taylor, Executive Director