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April 2, 2018

VIA ELECTRONIC FILING

Hon. David Jones, Chairman
c/o Sharla Dillon
Tennessee Public Utilities Commission
502 Deaderick Street, 4th Floor
Nashville, TN 37243

**RE: Tennessee-American Water Company's Response to Commission's
Investigation of Impacts of Federal Tax Reform on the Public Utility
Revenue Requirements, TPUC Docket No. 18- 00039**


Dear Chairman Jones:

Pursuant to the Commission's February 6, 2018, Order in Docket No. 18-00001, attached please find the *Response of Tennessee-American Water Company to Commission's Investigation of Impacts of Federal Tax Reform on the Public Utility Revenue Requirements*.

As required, an original of this filing along with four (4) hard copies will follow. A check in the amount of \$25.00 for the required filing fee will also be delivered. Should you have any questions concerning this filing, or require additional information, please do not hesitate to contact me.

Very truly yours,

BUTLER SNOW LLP


Melvin J. Malone

clw

Attachments

cc: Daniel Whitaker, Assistant Attorney General , Consumer Protection and Advocate Division (via email)
Karen H. Stachowski, Assistant Attorney General, Consumer Protection and Advocate Division (via email)

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TENNESSEE-AMERICAN WATER COMPANY, INC.

DOCKET NO. 18-XXXXX

TESTIMONY

OF

JOHN R. WILDE

ON

**TENNESSEE-AMERICAN WATER COMPANY'S CALCULATION OF IMPACTS OF
THE FEDERAL TAX CUTS AND JOBS ACT OF 2017 ON ITS COST OF SERVICE
AND REVENUE REQUIREMENT**

1 **Q. PLEASE STATE YOUR NAME.**

2 A. My name is John R. Wilde.

3 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

4 A. I am employed by American Water Works Service Company, Inc. ("Service Company")
5 as Senior Director - Tax. The Service Company is a subsidiary of American Water Works
6 Company, Inc. ("American Water") that provides services to American Water's
7 subsidiaries, including Tennessee-American Water Company ("Tennessee-American,"
8 "TAWC" or the "Company").

9 **Q. PLEASE OUTLINE YOUR EDUCATIONAL BACKGROUND AND BUSINESS**
10 **EXPERIENCE.**

11 A. I graduated from Saint Norbert College, De Pere, Wisconsin in 1984 with a Bachelor of
12 Business Administration Degree in Accounting. I have a graduate certificate in state and
13 local taxation, as well as a Master of Science Degree in Taxation from the University of
14 Wisconsin-Milwaukee. I have over 30 years of experience as a tax and accounting
15 professional serving utilities with regulated operations in multiple states. Before coming
16 to American Water, I spent fifteen years as the head of tax for a corporate group (WEC
17 Energy Group, Inc., formerly Integrys Energy Group, Inc.) that had six utilities with
18 operations in four states.

19 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION OR ANY**
20 **OTHER REGULATORY AGENCIES?**

21 A. Yes. I have testified before the Federal Energy Regulatory Commission, the Public Service
22 Commission of Wisconsin, the Michigan Public Service Commission, the Virginia State
23 Corporation Commission, the Illinois Commerce Commission, the Kentucky Public

1 Service Commission, the Minnesota Public Utilities Commission, Virginia State
2 Corporation Commission, Missouri Public Service Commission, and the Pennsylvania
3 Public Utility Commission.

4 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

5 A. On February 6, 2018, the Tennessee Public Utility Commission (the “PUC” or the
6 “Commission”) the Commission entered an Order Opening an Investigation and Requiring
7 Deferred Accounting Treatment (the “Order”) in Docket No. 18-00001, *In re: Tennessee*
8 *Public Utility Commission Investigation of Impacts of Federal Tax Reform on the Public*
9 *Utility Revenue Requirements*. The Order noted the passage of the federal Tax Cuts and
10 Jobs Act of 2017 (the “TCJA” or the “Act”) and directed the five largest utilities under the
11 Commission’s jurisdiction, including Tennessee-American, to do the following:

- 12 a. Track and accumulate monthly in a deferred account the
13 portion of its revenue representing the difference
14 between the cost of service approved by the Commission
15 in its most recent rate case and the cost of service that
16 would have resulted had the provision for federal income
17 taxes been based on 21 % rather than 35%; and
- 18 b. Calculate the excess deferred tax reserve caused by the
19 reduction in the corporate federal income tax rate and
20 recognize as a deferred liability the estimated reduction
21 of the utilities' revenue requirement resulting from the
22 2017 Tax Act; and
- 23 c. Calculate and defer any other tax effects resulting from
24 the 2017 Tax Act on revenue requirement that are not
25 included in the preceding calculations.
26
27
28

29 The Order further directed TAWC and other utilities to submit these calculations together
30 with proposals to reduce rates or make other ratemaking adjustments to account for the tax
31 benefits resulting from the TCJA.

1 The purpose of my testimony is to submit and explain Tennessee-American's calculations
2 of the tax effects of the Act. Company witness Linda Bridwell will present Tennessee-
3 American's proposal for ratemaking adjustments to account for the Act's tax benefits.

4 **Q. PLEASE GENERALLY DESCRIBE THE EFFECT OF THE TCJA ON TAWC'S**
5 **FINANCIAL OPERATIONS.**

6 A. The TCJA contains many provisions that substantially modify the Internal Revenue Code,
7 and full quantification of its impacts will take some time. The most obvious impact of the
8 TCJA is the reduction to TAWC's annual federal tax expense effective beginning in 2018
9 resulting from the corporate tax rate cut.

10 Another major impact is on TAWC's Accumulated Deferred Income Taxes ("ADIT"). For
11 over the last thirty years, TAWC's ADIT has been calculated based on the 35 percent
12 federal tax rate. As explained below, with the TCJA's reduction to that rate to 21%,
13 TAWC's estimated ADIT balance as of the enactment date of the legislation of ADIT is in
14 a net excess position, meaning that the Company's balance overstates the taxes that will be
15 payable in the future related to prior operations of the Company. I discuss the impact of
16 the TCJA on TAWC's ADIT balances below.

17 Other significant impacts of the Act relate to bonus depreciation, contributions in aid of
18 construction ("CIAC") and customer advances for construction ("CAC"), and employee
19 fringe benefits. Utilities will not be able to claim bonus depreciation on property placed in
20 service after September 27, 2017 unless construction had begun before that date, or the
21 property was acquired pursuant to a contract in place prior to that date; however, if
22 construction began prior to September 27, 2017 or the property was acquired subject to a
23 binding written contract entered into prior to that date, TAWC might be eligible for 50%

1 bonus depreciation on those property additions. More clarity is needed regarding the
2 transitional rules in the bonus provisions of the Act. CIAC and CAC are now 100%
3 taxable to the Company for contributions to construct utility plant received from outside
4 parties. Most recently, water utilities like TAWC were exempt from taxation for revenues
5 received for main extensions. Finally, the Act's changes will likely result in the loss of
6 deduction for some employee fringe benefits incurred in the context of TAWC regulated
7 operations, such as some meals and some parking provided to employee's that was
8 previously not taxed.

9 **Q. WHAT IMPACT WILL THE TCJA TAX CHANGES HAVE ON THE**
10 **COMPANY'S FEDERAL TAX EXPENSE?**

11 TAWC has calculated the reduction to its annual federal tax expense with respect to the
12 Company's base rates and its Capital Recovery Riders. The reduction of the corporate
13 federal income tax rate from 35% to 21% has reduced TAWC's annualized federal income
14 tax expense in base rates by an estimated \$2, 035, 031 million. See Petitioner's Exhibit
15 – Tax Expense Impact – LCB attached to Ms. Bridwell's testimony in this Docket. . The
16 change in tax rate has also reduced the Company's Capital Recovery Riders revenue
17 requirement by approximately \$630,000. That has been discussed extensively by Ms.
18 Bridwell in Docket No. 17-00124 and is not included in this Docket.

19 **Q. PLEASE DESCRIBE THE PROCESS FOR DETERMINING THE TCJA'S**
20 **IMPACT ON TAWC'S ADIT BALANCES.**

21 A. While the calculation of the impact that the reduction of the federal tax rate from 35% to
22 21% on income tax expense is relatively straightforward, the calculation of the estimated
23 impact the reduction of the federal tax rate on ADIT balances that need to be normalized

1 into future rates and executing a method to normalize the resulting excess is a complex and
2 involved process. It is also a process that takes significant time, requires great care, and
3 will likely go through several subsequent refinements before being considered an estimate
4 that could be reasonably relied on.

5 TAWC's ADIT balances are being remeasured based on a federal rate of 21%, and will
6 result in excess ADIT balances. These excess deferred taxes fall into two categories –
7 those that are subject to the normalization provisions of the Act (generally relating to plant-
8 related assets sometimes referred to as "protected" ADIT), and those that are not (generally
9 related to non-plant-related assets and sometimes referred to as "unprotected" ADIT).
10 Pursuant to tax normalization rules and practices, the protected excess deferred taxes can
11 be returned to customers, but no more rapidly than over what is allowed under one of two
12 approved normalization methods of accounting: the Average Rate Assumption Method
13 ("ARAM"); or the Reverse South Georgia Method ("RSGM). Both ARAM and RSGM
14 are what was allowed by the tax normalization rules enacted in the Tax Reform Act of
15 1986, and in general for a regulated utility to normalize or amortize the excess deferred
16 taxes into cost of service tax expense and ADIT over the remaining book depreciation lives
17 of the underlying assets. In contrast, the unrestricted excess deferred taxes can be
18 normalized into regulated tax expense and ADIT balance over any reasonable period.

19 **Q. WHY DO YOU SAY THAT THE PROCESS OF REMEASUREMENT AND**
20 **NORMALIZATION OF EXCESS ADIT BALANCES REQUIRES GREAT CARE?**

21 A. The remeasurement and normalization of excess ADIT balances requires great care
22 because errors could result in violations of the IRS normalization rules, which would harm
23 customers. The normalization rules require that the tax benefits of claiming accelerated

1 tax depreciation be provided to customers in rates over a period no less than the book
2 depreciation life of the underlying property.

3 The normalization rules also provide that for a utility to use a normalization method of
4 accounting for public utility property, the utility must use consistent methods of estimating
5 or projecting tax expense, depreciation expense or reserve from deferred taxes. Code
6 Section 168(i)(9)(B)(i), (ii). The rules specify:

7 Use of inconsistent estimates and projections. The
8 procedures and adjustments which are to be treated as
9 inconsistent for purposes of clause (i) shall include any
10 procedure or adjustment for ratemaking purposes which uses
11 an estimate or projection of the taxpayer's tax expense,
12 depreciation expense, or reserve for deferred taxes under
13 subparagraph (A)(ii) unless such estimate or projection is
14 also used, for ratemaking purposes, with respect to the other
15 2 such items and with respect to the rate base. Code Section
16 168(i)(9)(B)(ii).

17
18 In order to ensure the required consistency between the calculation of deferred tax and rate
19 base, the difference in the amortization of deferred tax excess and deficiencies cannot be
20 given to customers without making a corresponding adjustment to rate base.

21 **Q. WHAT ARE THE CONSEQUENCES OF FAILURE TO COMPLY WITH THE IRS**
22 **NORMALIZATION RULES?**

23 A. The penalties for failure to precisely comply with the IRS normalization rules are serious.
24 A violation could result in: (i) the potential loss of the utility's ability to continue to take
25 accelerated tax depreciation; and (ii) an increase in tax equal to the amount by which it
26 reduces its excess tax reserve more rapidly than permitted. This means, among other
27 things, that there would be no ADIT balance to reduce the utility's rate base, which would
28 be a detriment to customers.

1 **Q. HAVE YOU ESTIMATED TAWC’S EXCESS ADIT BALANCES?**

2 A. Yes. With the TCJA’s reduction to the corporate federal income tax rate, TAWC’s ADIT
3 balance as of the enactment date of the legislation is in a net excess position, meaning the
4 Company’s net ADIT balance overstates the taxes that will be payable in the future related
5 to prior operations of the Company. TAWC’s ADIT balance includes both deferred tax
6 assets (DTAs), and deferred tax liabilities (DTLs), each of which requires remeasurement
7 on the TCJA enactment date. For TAWC, the net of those DTAs & DTLs is an ADIT
8 liability balance and the remeasurement results in identification of a net excess deferred
9 tax liability. TAWC’s initial estimate of the net excess ADIT balances is \$17,487,688
10 total (protected/plant-related and unprotected/non-plant-related). Assuming a 50-year
11 normalization period which is the estimated average remaining service life, this balance
12 would be normalized and returned to customers in the amount of \$349,754 per year for 50
13 years. I must stress however that **these estimates are not suitable for ratemaking**
14 **purposes and will be revised as more information becomes available.**

15 **Q. WHY ARE THE COMPANY’S ESTIMATED EXCESS ADIT BALANCE AND**
16 **NORMALIZATION PERIOD NOT SUITABLE FOR RATEMAKING**
17 **PURPOSES?**

18 A. TAWC’s current estimate of its ADIT balance and normalization period are not suitable
19 for ratemaking because we have not yet determined the exact amounts of plant-related
20 ADIT (which is subject to IRS normalization requirements) and non-plant-related ADIT
21 (which is not), nor have we yet determined the applicable amortization periods. It is
22 important to get the balance estimates and amortization periods right in order to avoid

1 violations of the normalization rules and resulting harm to customers' interests discussed
2 above.

3 **Q. WHEN DOES TAWC EXPECT TO PRODUCE AN ADEQUATE ESTIMATE OF**
4 **ITS REMEASURED ADIT BALANCE AND APPLICABLE AMORTIZATION**
5 **PERIODS?**

6 A. While the process is unlikely to be completed by the end of 2018, the Company expects it
7 to be completed by the end of the first or second quarter of 2019.

8 **Q. HAVE YOU CALCULATED THE EFFECT OF OTHER PROVISIONS ON THE**
9 **COMPANY'S INCOME TAX EXPENSE?**

10 A. Not as of this date. The loss of bonus depreciation deductions will not have an impact until
11 TAWC net operating losses are fully utilized. TAWC is still working through the impact
12 of changes to bonus depreciation deductions. TAWC expects the impact of the loss of
13 certain employee related deductions to be insignificant. As Company witness Ms. Bridwell
14 explains, CIACs and CACs will be "grossed up" to cover the Company's tax obligation
15 associated with the CIAC/CAC.

16 **Q. WHAT IS THE COMPANY'S PROPOSAL WITH RESPECT TO THE**
17 **REDUCTION IN ITS CAPITAL RECOVERY RIDERS' REVENUE**
18 **REQUIREMENT RESULTING FROM THE TCJA?**

19 A. As explained by Company witness Linda Bridwell, Tennessee-American has adjusted its
20 2018 Capital Recovery Riders to reflect the TCJA's reduced federal income tax rate, and
21 future Riders will also reflect the new rate.

1 **Q. WHAT IS THE COMPANY’S PROPOSAL WITH RESPECT TO THE REDUCED**
2 **INCOME TAX EXPENSE IN BASE RATES AND EXCESS ADIT BALANCE**
3 **RESULTING FROM THE TCJA?**

4 **A.**As discussed by Company witness Linda Bridwell, Tennessee-American proposes to defer
5 both the reduction in the Company’s federal income tax expense in base rates and the ADIT
6 normalization amounts as regulatory liabilities and use them to offset the Company’s
7 Capital Recovery Riders and Capital Recovery Riders reconciliations, thus reducing our
8 customers’ Capital Recovery Rider charges.

9 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

10 **A.**Yes.

11