KENTUCKY-AMERICAN WATER COMPANY
CASE NO. 2018-00042
COMMISSION STAFF'S SECOND REQUEST FOR INFORMATION

Witness: John R. Wilde

1. Refer to Kentucky-American's response to Commission Staff's First Request for Information ("Staff's First Request") and its supplemental responses submitted on March 29, 2018 ("Supplemental Responses"), in general, where Kentucky-American largely declined to calculate the impact of the Tax Cuts and Jobs Act ("TCJA") on income tax expense and accumulated deferred income taxes ("ADIT"). State whether Kentucky-American agrees that the normalization requirements in the TCJA and Income Tax Code ("ITC") permit the use of estimates and projections in establishing utility rates and determining the impact of federal taxes on rates. State whether it would be reasonable for the Commission to rely solely on its own estimates and projections and those of intervenors in determining how to address the impact of the TCJA in a manner consistent with Kentucky and federal law in the event that Kentucky-American fails and/or refuses to estimate the impact on rates.

Response:

Kentucky American has provided an estimate of the impacts of the TCJA on income tax expense. At pages 5-8 of Mr. Wilde's January 26, 2018 testimony, he explained both the amount of income tax expense that that should be provided to customers ($5,404,718 for water customers and $14,160 for sewer customers). Those amounts were based on test periods in Kentucky American's most recent water and sewer rate cases (Case No. 2015-00418 and Case No. 2014-00390, respectively). Mr. Wilde further described that a rate reduction (as opposed to a line item credit) is the preferred method of providing those amounts to customers (see page 7 of his testimony).

As for ADIT, Kentucky American has also provided the financial accounting estimate [based on the reasonableness standard set forth in SAB 118 as issued by the SEC on 12/22/2017] of remeasurement of ADIT balances as of the date of enactment of the TCJA that resulted from the reduction of the federal corporate tax rate from 35% to 21%. (Please see Kentucky American's responses to Items 8 and 9 of Commission Staff's First Request for Information). These estimates are not suitable for ratemaking purposes. This process of re-measuring ADIT balances is a financial accounting concept that results in excesses and deficiencies in deferred tax assets and liabilities being recorded on the date of enactment. As a general matter, regulatory and tax accounting generally differ requiring that these excesses and deficiencies be factored into rate making after the date of enactment and normalized into tax expense and regulated ADIT balances over the underlying book life of the property. [See Section 1561(d) of the TCJA].

What Kentucky American has yet to have been able to do is calculate and provide an estimate of the normalization (amortization) of the excess and deficiencies in ADIT balances that would be consistent with the tax normalization rules. Since the economic consequences of a tax normalization violation will for the most part accrue to its current and future customers, Kentucky American has been proceeding with great care not to provide estimates or assumptions that could be incorrectly applied, and thus could result in a tax normalization violation.

For purposes of clarity and in an effort to be as cooperative as possible, Kentucky American agrees that accurate, relevant, and consistent estimates of tax expense and the ADIT balances are allowed and consistent with the tax normalization rules. Accuracy, relevance, and consistency as applied in this context go to those estimates being tied to and supported by the underlying estimated plant activity used to set rates for the same period. For example, if one estimates deferred tax expense and the resulting estimated change in an ADIT balance for claiming method life or tax repairs deduction in cost of service ratemaking, those estimated tax deductions should be reflective of plant balances and plant activity be used in the same cost of service ratemaking proceeding.

One fundamental question still being considered by Kentucky American that goes beyond the mere question of estimates is: Does Kentucky American qualify to utilize the Alternate Method provided for in the TCJA? Kentucky American has not yet been able to determine with any certainty that it can use the Alternate Method. Although American Water owns the software that would be utilized to do this, the Company has not developed and maintained its accounting records to the level of detail that will allow it to estimate ARAM and expects that it will take until the first or second quarter of 2019 to populate the data from the existing records. Because Kentucky American does not have the records to be able to determine with any certainty that it can use the Alternative Method, using any estimate of the Alternate Method may cause a violation. So, while Kentucky American concurs that estimates are allowed, until the fundamental legal question is answered, Kentucky American believes there is no basis make any estimate.

Further, Kentucky American believes that it is not reasonable for the Commission to rely solely on its own estimates and projections and those of intervenors in determining how to address the impact of the TCJA in a manner consistent with Kentucky and federal law. Kentucky American would like to emphasize that the Company is not taking a position that it refuses to provide the requested information on ADIT reduction normalization. The Company is in a position where it cannot reasonably make even an estimate of the requested information at this time, but expects to be able to do so in the near future. For the Commission to rely solely on its own estimates and projections, and require Kentucky American to address the impact of the TCJA in a manner that may cause a normalization violation will leave Kentucky American in the position that it will be necessary for the Company to self-report the potential normalization violation. The potential consequences if it is determined to be a normalization violation, can include the loss of accelerated depreciation in its entirety. The potential impact of the loss of accelerated depreciation in its entirety would be a significant impact and disservice to Kentucky American customers.

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Witness: Linda C. Bridwell

2. Using Kentucky-American's Supplemental Responses submitted March 29, 2018 ("Supplemental Responses"), and the table below, provide the revenue reduction for Kentucky-American's sewer division resulting from the decrease in the Federal Income Tax ("FIT") rate from 35 percent to 21 percent.

Line No.	Description	35% Federal Income Tax Rate	21% Federal Income Tax Rate	Revenue Impact
1	Operating Expenses Net of Income Taxes			
2	Divide by: 88% Operating Ratio			
3				
4	Required Annual Operating Income Before Income Taxes (Line 1 / Line 2)			
5	Multipled by Income Tax Gross-up Factor			
6				
7	Required Operating Income After Taxes (Line 4 x Line 5)	$ -	$ -	$ -

Response:

In an effort to respond fully to this request for information, Kentucky American has prepared the following table, duplicating what it believes the Commission has requested based on the 2017 sewer division expenses. Please note, however, that Kentucky American respectfully believes that the Commission has omitted necessary lines for this calculation that cause the calculation to generate a much higher revenue impact than would actually occur. If Kentucky American understands the question as posed, the requested calculation produces a tax gross up factor on all income, not the net operating income. Kentucky American has prepared Table 1 in an effort to be as fully responsive as possible. However, Kentucky American has also prepared Table 2, which shows the information that the Company believes is at the root of the Commission's question based on the Commission's Alternative Rate Filing Form 1 – Attachment RR - OR.

Further, Kentucky American strongly believes that using the calendar year 2017 expenses is not appropriate, for two reasons. First, Kentucky American's current sewer rates were established in Case No. 2014-00390. Kentucky American proposed in its initial filing on January 26, 2018 what it believed to be the appropriate rate reduction based on the tax expense calculation in that case. (See Mr. Wilde's testimony at pages 5 – 9). In Exhibit A to Mr. Wilde's testimony, Kentucky American used the Operating Expenses and taxes from its initial filing in Case No. 2014-00390, not the adjusted numbers from the Commission Staff report on which the rates are established. Kentucky American has prepared Table 3 utilizing the Operating Expenses determined in the Commission Staff report in Case No. 2014-00390, based on Alternative Rate Filing Form 1 – Attachment RR-OR. If any reduction is going to be made to authorized rates, it should be based on authorized rates. Second, as is evident from the Company's last three sewer utility commission reports, sewer revenues are less than sewer expenses. As a result, no tax expense has been shown and net income has actually been negative. So if the sewer utility is to be viewed in sum, rather than as authorized rates from 2014-00390, there would be no reduction in rates warranted.

Table 1
Calculations of Revenue Impact Utilizing PSC Requested Calculations
2017 Actual Sewer Operating Expenses

Line No.	Description	35% Federal Income Tax Rate	21% Federal Income Tax Rate	Revenue Impact
1	Operating Expenses Net of Income Taxes	$ 889,819.00	$ 889,819.00	
2	Divide by: 88% Operating Ratio	0.88	0.88	
3				
4	Required Annual Operating Income Before Income Taxes (Line 1/ Line 2)	$ 1,011,157.95	$ 1,011,157.95	
5	Multiplied by Income Tax Gross-up Factor	$ 1.63666	1.34662	
6				
7	Required Operating Income After Taxes (Line 4 x Line 5)	$ 1,654,923.00	$ 1,361,645.51	$ (293,277.49)

Table 2
Calculations of Revenue Impact Utilizing Adjusted PSC Requested Calculations
2017 Actual Sewer Operating Expenses

Line No.	Description	35% Federal Income Tax Rate	21% Federal Income Tax Rate	Revenue Impact
1	Operating Expenses Net of Income Taxes	$ 889,819.00	$ 889,819.00	
2	Divide by: 88% Operating Ratio	0.88	0.88	
3				
4	Required Annual Operating Income Before Income Taxes (Line 1/ Line 2)	1,011,157.95	1,011,157.95	
5	Less: Pro forma Operating Expenses Before Income Taxes	(889,819.00)	(889,819.00)	
6				
7	Net Income Allowable	121,338.95	121,338.95	
8	Multiplied by Income Tax Gross-up Factor	1.63666	1.34662	
9				
10	Net Income Before Taxes	198,590.76	163,397.46	
11	Provision for State and Federal Income Taxes (Line 10 - Line 7)	77,251.81	42,058.51	
12				
13	Required Operating Income After Taxes (Line 4 + Line 11)	$ 1,088,409.76	$ 1,053,216.46	$ (35,193.30)

Table 3
Calculations of Revenue Impact Utilizing Adjusted PSC Requested Calculations
Case No. 2014-00390 Operating Expenses Net of Income Taxes

Line No.	Description	35% Federal Income Tax Rate	21% Federal Income Tax Rate	Revenue Impact
1	Operating Expenses Net of Income Taxes	$ 373,510.00	$ 373,510.00	
2	Divide by: 88% Operating Ratio	0.88	0.88	
3				
4	Required Annual Operating Income Before Income Taxes (Line 1/ Line 2)	424,443.18	424,443.18	
5	Less: Pro forma Operating Expenses Before Income Taxes	(373,510.00)	(373,510.00)	
6				
7	Net Income Allowable	50,933.18	50,933.18	
8	Multiplied by Income Tax Gross-up Factor	1.63666	1.34662	
9				
10	Net Income Before Taxes	83,360.36	68,587.64	
11	Provision for State and Federal Income Taxes (Line 10 - Line 7)	32,427.18	17,654.46	
12				
13	Required Operating Income After Taxes (Line 4 + Line 11)	$ 456,870.36	$ 442,097.64	$ (14,772.72)

Witness: John R. Wilde/Linda C. Bridwell

3. Refer to Kentucky-American's response to Commission Staff's First Request for Information ("Staff's First Request"), Item 9. This response was nonresponsive. Kentucky-American stated that it would not complete the requested template computing a reduction in revenue requirements, because it believes that doing so would be imprudent, because of the possibility of violating tax normalization rules. However, Kentucky-American did not directly explain why it would be considered a violation of the normalization rules to compute the impact of the FIT rate reduction on the current income tax expense. Using the Rate Base for the calendar year ended December 31, 2017 provided in the response to Staff's First Request, Item 2, the Weighted Average Cost of Capital's ("WACC") Kentucky-American calculated in the Supplemental Responses, Item 7, and the table below, provide the revenue reduction resulting from the decrease in the FIT rate from 35 percent to 21 percent.

Line No.	Description	35% Federal Income Tax Rate	21% Federal Income Tax Rate	Revenue Impact
1	Rate Base Allocated to Kentucky Jurisdiction			
2	Required Rate of Return Adjusted for Income Taxes			
3				
4	Required Annual Operating Income Before Taxes (Line 1 x Line 2)	$ -	$ -	$ -

Response:

With all due respect, Kentucky American has provided an estimate of the water revenues reduction associated with the change in tax expense. That amount is $5,404,718. Kentucky American has also proposed a method for delivering that amount to customers. Please see Mr. Wilde's January 26, 2018 testimony and pages 5 – 8. Please also see Kentucky American's response to Item 1.

With respect to ADIT, Kentucky American's concern is limited to its current ability to provide an estimate for the normalization of excess ADIT that is consistent with the tax normalization rules. "Normalization," as defined in Rev Proc 2017-47, refers to a system of accounting to reconcile tax treatment of the investment tax credit or accelerated depreciation of assets with their regulatory treatment. Under the normalization rules, a public utility receives a tax benefit in the early years of an asset's regulatory useful life, and then passes that benefit on to its customers through rates over the regulatory useful life of the asset, in the form of reduced rates. Sanctions imposed under the normalization rules have always been intended to discourage the flow-through of tax benefits to customers, so the utilities could benefit from the provisions to encourage investment while protecting the government's tax revenue.

The consequences of violation of the tax normalization rules as outlined in the TCJA are significant. Per Section 1561(d)(4) of the TCJA:

(4) Tax increased for normalization violation.—If, for any taxable year ending after the date of the enactment of this Act, the taxpayer does not use a normalization method of accounting for the corporate rate reductions provided in the amendments made by this section—
(A) the taxpayer's tax for the taxable year shall be increased by the amount by which it reduces its excess tax reserve more rapidly than permitted under a normalization method of accounting, and
(B) such taxpayer shall not be treated as using a normalization method of accounting for purposes of subsections (f)(2) and (i)(9)(C) of section 168 of the Internal Revenue Code of 1986.

In other words, regarding (B), the Company would lose its ability to take accelerated depreciation for tax purposes. Only inadvertent or unintended violation of those rules can be cured with subsequent action by the taxpayer and respective commission [See Rev Proc 2017-47].

Kentucky American is simply seeking a delay or deferral of the normalization of excess ADIT until it has had ample time to compute an estimate that would insure that estimate was computed consistent with the tax normalization rules. Once Kentucky American completes an estimate of the normalization of ADIT, it would incorporate both the deferred normalization amount and the ongoing normalization amount as future rates are set.

With that said, Kentucky American has calculated the revenue reduction resulting from the decrease in the FIT rate from 35 percent to 21 percent as requested by the Staff in this Discovery Request. Kentucky American has utilized the Rate Base for the calendar year ended December 31, 2017 provided in the response to Staff's First Request, Item 2 and the Weighted Average Cost Kentucky American provided in its Supplemental Response to Staff's First Request, Item 7:

Line No.	Description	35% Federal Income Tax Rate	21% Federal Income Tax Rate	Revenue Impact
1	Rate Base Allocated to Kentucky Jurisdiction	410,877,481.00	410,877,481.00	
2	Required Rate of Return Adjusted for Income Taxes	9.920%	8.702%	
3				
4	Required Annual Operating Income Before Taxes (Line 1 x Line 2)	$ 40,759,046.12	$ 35,754,558.40	$ (5,004,487.72)

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Witness: Linda C. Bridwell/Scott Rungren

4. Refer to Kentucky-American's response to Staff's First Request, Item 10. This response was nonresponsive. Using the Capital Structure for the calendar year ended December 31, 2017 provided in the response to Staff's First Request, Item 2, the WACC's Kentucky-American calculated in the Supplemental Responses, Item 7, and the table below, provide the revenue reduction resulting from the decrease in the FIT rate from 35 percent to 21 percent.

Line No.	Description	35% Federal Income Tax Rate	21% Federal Income Tax Rate	Revenue Impact
1	Capitalization Allocated to Kentucky Jurisdiction			
2	Required Rate of Return Adjusted for Income Taxes			
3				
4	Required Annual Operating Income Before Taxes (Line 1 x Line 2)	$ -	$ -	$ -

Response:

Kentucky American has attempted to provide the information requested, using the 2017 Capitalization provided in response to Staff's First Request, Item 2, and the 2017 rate of return provided in the Supplemental Response to Staff's First Request, Item 7.

Line No.	Description	35% Federal Income Tax Rate	21% Federal Income Tax Rate	Revenue Impact
1	Capitalization Allocated to Kentucky Jurisdiction	$ 411,772,722	$ 411,772,722	
2	Required Rate of Return Adjusted for Income Taxes	9.920%	8.702%	
3				
4	Required Annual Operating Income Before Taxes (Line 1 x Line 2)	$ 40,847,854	$ 35,832,462	$ (5,015,392)

As Kentucky American provided in its direct filed testimony, the Company's currently authorized rates established in Case No. 2015-00418 were based on the forecasted test period ending August 31, 2017.

Witness: John R. Wilde

5. Refer to Kentucky-American's responses to Staff First Request, Item 2, Attachment 1, KAW_R_PSCDR1_NUM002_032718_Attachment_1, Tab TB.

a. For each general ledger account listed in the table below, provide the complete account title and a detailed description of what is recorded in each account.

G/L Account	Account	NARUC	December-17
RA-ITRtR-Plant F/T	18504000	C1863	0.38
RA-ITRtR-Other	18504500	C1863	(236,237.27)
Def FIT LiabNormProp	25310000	C283	(11,936.00)
Def FIT Liab-Other	25311000	C283	(38,266,672.09)
Def SIT Liab-Other	25321000	C283	(8,231,840.14)
RL-ITRR-ExcDef FIT	25621000	C2531	(44,003,167.00)
RL-ITRR-ExcDefDprFIT	25621200	C2531	(17,567.23)
RL-ITRR-Deficit Def	25622000	C2531	3,267.84
RL-ITRR-ExcDefDpSIT	25623200	C2531	(1,131,040.55)
RL-ITRR-ITC GrUp3%	25626000	C2531	(17,144.75)
RL-ITRR-ITC GrUp4%	25626100	C2531	0.15
RL-ITRR-ITC GrUp10%	25626200	C2531	(190,858.34)

b. For each federal ADIT account listed in the table in 4.a. identify and explain if the TCJA would classify it as protected or unprotected.

c. Identify each and every federal ADIT account listed in the table in 4.a. in which the ADIT or any portion thereof was generated or arose from accelerated or bonus federal tax depreciation of "public utility property," assuming that "public utility property" is defined as property used predominantly in the trade or business of furnishing or sale of water or sewage disposal services for which the rates for such furnishing or sale were set by the Kentucky Public Service Commission or another regulatory entity.

d. Identify any and all other accounts not identified in response to Item 4.c., if any, that represent federal ADIT in which the ADIT or any portion thereof was generated or arose from accelerated or bonus federal tax depreciation of "public utility property," assuming that "public utility property" is defined as property used predominantly in the trade or business of furnishing or sale of water or sewage disposal services for which the rates for such furnishing or sale were set by the Kentucky Public Service Commission or another regulatory entity, by providing the same information included in the table in Item 4.a.

e. For each account identified in response to Item 4.c. and Item 4.d., state whether all of the ADIT was generated by, or arose from, accelerated or bonus federal tax depreciation of "public utility property" as that term is defined in Item 4.c. and 4.d. If all of the federal ADIT identified in those accounts did not arise from accelerated or bonus federal tax depreciation of "public utility property," please identify and describe in detail the source of ADIT, including a description of all assets and property related to the ADIT and any tax provision and treatment that generated or gave rise to the ADIT. If all of the federal ADIT identified in those accounts did not arise from accelerated or bonus federal tax depreciation of "public utility property," calculate, based on estimates and projections if necessary, any and all of the ADIT that was generated by or arose from accelerated or bonus federal tax depreciation of "public utility property" as that terms is defined in Item 4.c. and 4.d. If estimates and projections were made to calculate the amounts herein, please identify and describe any estimates and projections used and explain why Kentucky-American contends that those estimates and projections are reasonable.

f. For each account identified in response to Item 4.c. and Item 4.d. as containing ADIT generated by or arising from the accelerated or bonus depreciation of public utility property, state what portion of the ADIT represented in those accounts has been assigned or attributed to Kentucky-American's regulated water business in Kentucky; what portion has been assigned or attributed to Kentucky-American's regulate sewage disposal business in Kentucky; and describe what business or other entity to which Kentucky-American has assigned or attributed other portions, if any, of the ADIT represented in those accounts, the amounts of ADIT assigned or attributed to each such entity, and why the ADIT was assigned or attributed to that entity.

Response:

a. See attached.

b. The Company does not have its accounts separated by protected and unprotected, nor does it have the underlying records to make such a split. However, for ADIT exclusive of the FAS 109 regulatory accounts, the Company is able to determine the split between plant related ADIT and non plant related ADIT. The Regulated Asset and Liability accounts track the effects of the following events: (1) the normalization requirements, when flow through was no longer allowed; and (2) any federal and state rate changes. The ADIT accounts are mostly separated by federal and state and not in any further detail, but breakdown as mentioned above is available in the tax provision system.

c. See response to (b).

d. All accounts are listed in the table.

e. The balances in the ADIT accounts listed in the table above were generated from plant and non-plant sources. The underlying support for the ledger balances is maintained in our tax provision software (Onesource Tax Provision). The depreciation computations, which are the largest piece, are maintained in depreciation software (PowerTax Depreciation & PowerPlant) and entered manually into the tax provision software. There is another module of PowerTax called the PowerTax Deferred module that calculates and maintains the protected and unprotected ADIT in the detail requested, however to date we have not implemented that module. The rest of the ADIT balance comes from differences between the treatment for book and the treatment for tax on non-plant related items, such as employee benefits and bad debt. Please see the attachment labeled KAW_R_PSCDR2_NUM009_Attachment. Also please see the response to Item 11 of these same requests.

f. While the Company can run a water and a sewer book depreciation report and a separate water and sewer tax depreciation report, the ADIT is not maintained at the same level because the PowerTax Deferred module needs to be implemented to compare the two and calculate the ADIT.

Kentucky-American Water
PSCDR2_NUM005 (a)

Account	FAS 109 Amortization	Explanation of Amortization
18504000	Reg Asset - Plant Flow Through	Regulatory asset for the adoption of FAS 109 related to UPIS depreciation timing differences up to the time of adoption
18504500	Reg Asset - Other	Regulatory asset for the adoption of FAS 109 related to timing differences other than UPIS depreciation up to the time of adoption
25621000	Reg Liability - Excess Deferred FIT	Regulatory liability for the excess federal deferred taxes due to federal rate change to 21%.
25621200	Reg Liability - Excess Deferred FIT	Regulatory liability for the excess federal deferred taxes due to federal rate change to 34%.
25622000	Reg Liability - Deficit Deferred FIT	Regulatory liability for the deficit federal deferred taxes due to the federal rate change to 35% from 34%.
25623200	Reg Liability - Excess Deferred SIT	Regulatory liability for the excess state deferred taxes due to state rate change.
25626000	Reg Liability - ITC Gross up - 3%	Regulatory liability for the adoption of FAS 109 to gross-up ITC. (Must gross-up ITC in order to offset related deferred taxes)
25626100	Reg Liability - ITC Gross up - 4%	Regulatory liability for the adoption of FAS 109 to gross-up ITC. (Must gross-up ITC in order to offset related deferred taxes)
25626200	Reg Liability - ITC Gross up - 10%	Regulatory liability for the adoption of FAS 109 to gross-up ITC. (Must gross-up ITC in order to offset related deferred taxes)
25310000	Deferred FIT Liability - Normalized Property	Federal deferred taxes. This account is generally not used any more since most federal deferred taxes are booked to 25311000. Minor amount still sitting in here but netted with 25311000.
25311000	Deferred FIT Liability - Other	Federal deferred taxes per GAAP
25321000	Deferred SIT Liability - Other	State deferred taxes per GAAP

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Witness: John R. Wilde

6. Identify and described any and all assets, accounts and property that Kentucky-American contends, based on current information and knowledge, meet the definition of "public utility property," as used in the TCJA, the depreciation of which generated or gave rise to ADIT by providing the description of the "public utility property" as used by Kentucky-American for the purpose of identifying the property in its records of regulated book depreciation; providing the description of the "public utility property" as used by Kentucky-American for the purpose of identifying the property in its records of tax depreciation; identifying the ADIT (without any offsets if any) generated from the accelerated or bonus tax depreciation of each property as of December 31, 2017; identifying any offsets that Kentucky-American contends should be applied to the ADIT and why; identifying the tax basis for each property as of December 31, 2017; identifying the date at which the property was placed in service; identifying the original tax basis for each property before it was depreciated in any manner for tax purposes; identifying the remaining useful life of the property as of December 31, 2017 based on the regulatory depreciation schedule currently used by Kentucky-American as established in its last rate case (if unknown, then provide the remaining useful life based on the depreciation schedule used by Kentucky-American in its regulated books as of December 31, 2017); and identifying the value of the property as used in Kentucky-American's regulated books as of December 31, 2017. If Kentucky-American contends that there is uncertainty regarding whether a particular asset, account or property would meet the definition of "public utility property," as used in the TCJA, provide the information requested hereinabove and explain in detail as to each such asset, account, or property why there is uncertainty and if so how that uncertainty may be resolved, including a description of what the property is used for. To the extent any of the information requested herein may be provided in an excel or other spreadsheet, please provide the spreadsheet.

Response:

Substantially all of the property owned by Kentucky American is public utility property, and, as such, is subject to the normalization provisions. In addition, the Company agreed as a condition of its consent agreement with the IRS related to its repairs method changes to normalize the effects of repairs. Therefore, nearly all of the plant related differences are protected.

See attachments KAW_R_PSCDR2_006_Attachment1, KAW_R_PSCDR2_006_Attachment2, and KAW_R_PSCDR2_006_Attachment3. Attachment1 shows the 2017 Kentucky American trial balance with book plant basis amounts and descriptions. Highlighted items in the trial balance are non-utility property.

This ties into Attachment2 which is a report from our PowerPlant systems which house our book basis and depreciation records and shows the non-utility property. Attachment3 shows the tax basis and depreciation from our PowerTax system and its descriptions which are not the same as the book. A mapping between the two, within the PowerTax deferred module system needs to be implemented in order to calculate ADIT on plant items properly.

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Witness: John R. Wilde

7. Kentucky-American stated in Case No. 2012-00520 that by the end of the forecasted test year, it would have booked $3,922,247 to the Financial Accounting Standards Interpretation No. 48 ("FIN 48") liability account.[1] Identify the account where Kentucky-American books the FIN 48 liability and the FIN 48 liability balance as of December 31, 2017.

Response:

In Case 2012-00520, for data request AG, Set 2, number 13(a), the response was

> *a.) For the base period, ADIT was reduced for FIN 48 by $2,646,706 and for the future period, the ADIT was reduced for FIN 48 by $3,922,247*

The FIN 48 amounts included in ADIT are booked to accounts 25311000 and 25321000, as set forth in the response to Item 5(a) of this same request for information.

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[1] Case No. 2012-00520, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, (Ky. PSC Oct. 25, 2013) at 19.

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Witness: John R. Wilde

8. In Case No. 2012-00520 Kentucky-American stated that the ratepayers would benefit if the IRS allows the FIN 48 deductions or the statute of limitations expires. Identify the date the statute of limitations will expire on the FIN 48 deductions.

Response:

To be clear, the deduction mentioned above refers to the repairs deduction. Ratepayers will benefit if the IRS ultimately allows the repairs deduction or the statute of limitations expires on the associated FIN 48 reserve. Please see page 3 of the May 15, 2013 testimony of Carl Meyers in Case No. 2012-00520. Please also see the Commission's October 25, 2013 Final Order.

Specifically, the statute of limitations expires in various years. The original repairs deduction, taken on the 2008 tax return, expires 3 years after the final net operating loss generated from 2008 is used on a tax return. The NOL from 2008 has not been fully used as of 2017 but due to the TCJA, it may be utilized faster than previously estimated. For example, if it is all utilized on the 2019 tax return, which will be filed in October 2020, the statute of limitations ends in October 2023.

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Witness: John R. Wilde

9. Refer to the responses to the Staff's First Request, Item 9.

   a. Kentucky-American provided for purposes of discussion excess ADIT related to plant of $30,163,661 and the excess for non-plant of $2,618,551. Confirm that the non-plant is the unprotected ADIT and the Plant is the protected. If this cannot be confirmed, provide an explanation.

   b. Provide copies of the work papers, assumptions, and the calculations Kentucky-American used to estimate the excess ADIT's referenced in Item 7.a.

   c. Identify the amount of excess ADIT that is associated with the FIN 48 liability and if it is reported in the protected or the unprotected estimates.

   d. Kentucky-American states that it has developed a reasonable estimate to simulate an amortization period for the protected ADIT pursuant to Reverse South Georgia Method ("RSGM"). Provide the Kentucky-American's estimated RSGM amortization period.

   e. Calculate Kentucky-American's estimate of the amortization of excess protected ADIT using RSGM.

   f. Explain why the 2008 consent decree with the IRS, requiring Kentucky-American to use a normalized method of accounting for tax repairs, would affect the amortization of the protected ADIT.

   g. Kentucky-American states that it requires greater precision to be able to estimate excess ADIT for rate purposes and that it will be able to do so in the first or second quarter of 2019. Provide a detailed explanation of what Kentucky-American will know in 2019 that will enable it to calculate a more accurate estimate of excess ADIT than it can calculate now and the degree to which the 2019 estimate will be more accurate than a current estimate.

Response:

a. Protected property would include depreciation differences in book/tax plant related to method and life differences. For Kentucky American, it would also include its ADIT related to repairs due to a condition dictated by the IRS when granting consent to Kentucky American's method change request. Unprotected plant property would include any differences in book/tax plant not related to method and life differences or repairs. The Company does not have the ability to breakout the unprotected plant differences, however the Company believes they will be minor given that the repair difference is also considered protected. Non-property related items are also unprotected differences.

b. Please see the attachment labeled KAW_R_PSCDR2_NUM009_Attachment.

c. FIN 48 is a deferred tax asset, therefore it is a deficit and not an excess. Because it is related to the repairs deduction, we would propose to treat it in the same manner as repairs, treating it similar to protected ADIT.

d. Kentucky American took book depreciation for 2017 and divided it into net book basis (book basis minus accumulated depreciation) and came up with 30 years. The Company has not been able to determine at this point if it qualifies for usage of RSGM and is still looking into the reasonableness of using the 30 year life even if it is allowed to use the RSGM. We believe we will have the information by the end of the first quarter of 2019 or early in the second quarter of 2019.

e. The Company does not have a total protected ADIT, but using the method in (d) and the plant amount previously provided, the estimated amortization would be $30,163,661 divided by 30 years or $1,005,455 per year. That said, again, we need to caution that these estimates are not suitable for ratemaking purposes. Kentucky American has not been able to determine if it qualifies to use RSGM, and using these amounts before knowing with certainty risks a violation of normalization rules and loss of accelerated depreciation.

f. The ADIT related to repairs is protected and therefore will be included in the amortization of the protected piece. To not do so would mean that the Company is in violation with the agreement it made with the IRS in 2008. If that occurs, the change in method would be deemed not to have been granted, and the amount of the repair deduction would be reversed. In that case, the deferred taxes would be paid back to the government through increased tax liability, and there would be no excess deferred tax to refund to customers.

g. The Company will be finalizing its analysis of whether it qualifies with certainty to use RSGM. The Company expects this analysis to be finalized in the first or second quarter of 2019. Assuming it cannot conclude it qualifies by the first quarter of 2019, the Company will have implemented a system to calculate ARAM using the PowerTax Deferred module, explained further in response to question 11 of this same request for information.

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Witness: John R. Wilde

10. Explain if the majority of the 2017 unprotected ADIT is recorded in Kentucky-American's "FIN" 48 liability Account.

Response:

Please refer to the response to Item 9(c) of this same request for information.

Witness: John R. Wilde

11. In its response to Item 17 of Staff's First Request, Kentucky-American states that it is using the software package PowerTax. In responding to a Commission Staff Post Hearing Request, Item 22.a. in Case No. 2017-00321 on March 23, 2018, Duke Energy Kentucky Inc. ("Duke Kentucky") provided a file that contains every record maintained in Duke Kentucky's PowerTax system that supports the PP&E Deferred Taxes and includes a pivot table that helps to summarize the details into Protected vs. Unprotected excess deferred taxes. Provide the same file or a file that contains the same information to the extent that Kentucky American's PowerTax system will allow. If Kentucky-American is physically or technologically not able to produce or does not have some of the information contained in Duke Kentucky's file, provide a similar file with any and all other information that Kentucky-American is able to provide and explain why Kentucky-American is not able to provide the information included in the file produced by Duke Kentucky and not included in the file produced by Kentucky-American. Define any column or category heading in any document produced.

Response:

This question goes to the heart of the issue and highlights the unique position that Kentucky American is currently in.

There are multiple modules marketed by Power Plan Consultants, the owner / developer of the relevant software. Kentucky American has implemented the PowerTax depreciation module and also uses PowerPlant which maintains the book plant records. The module that Duke Kentucky would be using is the Deferred Tax module which is part of PowerTax. This module allowed them to produce the report they provided, and this module interfaces with the tax basis contained in power tax as well as drawing data from Powerplant. It is this module that develops and tracks vintage records needed to do ARAM. Kentucky American, along with all of American Water, has not implemented this module, but plans to do so in the next year. This module will calculate and maintain the plant deferred taxes in the detail necessary to calculate protected and unprotected deferred taxes. It loads data from the book and tax depreciation modules. In addition, it tracks method and life separately from other differences and, as such, there is the ability to track protected and unprotected deferred taxes separately. While the tax data is vintaged, the book data is not because it uses a group composite rate for book depreciation and the accumulated book depreciation is not vintaged in the system.

This is the reason that Kentucky American is concerned it does not qualify for RSGM. Because it owns the systems necessary to do ARAM, but has not implemented and converted its data, it is concerned the IRS would not determine that Kentucky American is qualified to do RSGM. Kentucky American has vintage plant and tax basis information in PowerTax, thus has the records and systems to do what others have done. It just has not executed. That said, until an implementation occurs, Kentucky American cannot ensure any excess refund is done equal to or slower than ARAM.

Kentucky American has not implemented this functionality previously because it has never needed to do so. The only other time that excesses were discussed in terms of normalization was the tax reform act of 1986 when rates went from 46% to 34%. At the time of that change, it was clear that Kentucky American qualified to use RSGM and as such has utilized that method. Given it never needed to do ARAM, there was never a need to incur the costs necessary to do ARAM. The requested information is exactly the information that will be required to implement to PowerTax module and that Kentucky American will be spending part of the next year compiling as part of the effort to finish the analysis. Kentucky American has the vintage plant and tax basis information required to utilize PowerTax, and thus has the records and systems to do what others have done. The data has simply not been uploaded and mapped, and is not currently in a system that will allow the Company to readily put it in a table as requested at this time.

Witness: John R. Wilde

12. Please admit or deny that the TCJA permits excess federal ADIT that arose from accelerated or bonus tax depreciation of public utility property to be amortized in computing a utilities cost of service for ratemaking purposes using the alternative method, also known as the Reverse South Georgia Method, if the utility lacks the information necessary to apply ARAM. Explain the basis for your response.

Response:

Per TCJA Section 1561(d)(2):

(2) Alternative method for certain taxpayers.—If, as of the first day of the taxable year that includes the date of enactment of this Act—
(A) the taxpayer was required by a regulatory agency to compute depreciation for public utility property on the basis of an average life or composite rate method, and
(B) the taxpayer's books and underlying records did not contain the vintage account data necessary to apply the average rate assumption method,

the taxpayer will be treated as using a normalization method of accounting if, with respect to such jurisdiction, the taxpayer uses the alternative method for public utility property that is subject to the regulatory authority of that jurisdiction.

While an alternative method is provided for, the Company must meet both (A) and (B) above. Otherwise, the Company must use the average rate assumptions method (ARAM). The Company is required to compute book depreciation on the composite rate method but item (B) is not as clear cut. Kentucky American has vintage plant, and vintage tax information, so it likely has the information needed to execute ARAM. Further, Kentucky American uses PowerPlant and PowerTax which are systems capable of building out the ARAM record and executing the method. Although the Company has not implemented it yet, it can likely do ARAM with time and therefore most likely cannot say it "lacks the information to apply ARAM" which is the vintage account data necessary to apply the average rate assumption method. RSGM is not a choice. The Company would need to prove it cannot do ARAM, per a standard of proof the IRS has not yet made clear as it relates to TCJA.

Witness: John R. Wilde

13. State whether Kentucky-American has the information necessary to calculate the rate at which excess federal ADIT may be amortized using ARAM such that it could perform the calculation as of the date of its response to this Item. If Kentucky-American currently does not have the information necessary to calculate ARAM, describe all information that it lacks in detail as of the date of its response to this Item, state whether or not it currently knows if it will be able to obtain that information, describe what it is currently doing to obtained that information, and state when it contends it will know whether or not it is able to obtain each item of information and why it will take until then to make that determination as to each item of information.

Response:

Please see the responses to Items 9(g) and 11 of this same request for information.

Witness: Linda C. Bridwell

14. State whether Kentucky-American agrees that it was required by the Kentucky Public Service Commission to compute depreciation for public utility property on the basis of either an average life or composite life. If you do not agree, please explain the basis for your response.

Response:

Kentucky American agrees that the annual depreciation accrual rates utilized and authorized by the PSC in Case No. 2015-00418 were calculated using the straight line remaining life method, using the average service life procedure.

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Witness: John R. Wilde

15. Refer to Kentucky-American's response to Item 9 of the Staff's First Request in which Kentucky American states "while the question may contemplate that the necessary offsets in revenue requirements would be addressed pursuant to setting rates." Identify any and all offsets you are referring to therein by describing the offsets; providing the amount of each offset that Kentucky-American contends should apply, why Kentucky American contends that each offset should apply; and the effect that Kentucky-American contends each offset should have on the revenue requirements.

Response:

The statement was made with the consistency rules in mind and not with specific amounts in mind.

Per IRC Section 1.167(1)-1(h)(6)(i):

a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking.

The calculation in Kentucky American's response to Item 9 of the Staff's First Request for Information did not include any adjustments to rate base due to the amortization of the excess into cost of service. As the amortization occurs, the ADIT in rate base is adjusted by the same amount and has an effect on the overall revenue requirement.

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Witness: John R. Wilde

16. Refer to the definition of "excess tax reserve" in the TCJA. State whether Kentucky-American agrees that the definition of "excess tax reserve" as used in the TCJA contemplates calculating the "excess tax reverse" using historical data available as of December 31, 2017. Explain the basis for your response in detail.

Response:

Kentucky American does not agree with the statement in the question. The definition of excess tax reserve provides no such direction that the calculation is necessarily limited to available data as of December 31, 2017. The definition simply defines the date that excess tax reserves would be measured. The IRS does as a general matter require a taxpayer to take into account all information relevant to a date or period set by date, and would incorporate information relevant to that period that became available or known after that date.

The definition of "excess tax reserve" in the TCJA (Section 1561 (d)(3)(A)) is:

> (A) Excess tax reserve.—The term "excess tax reserve" means the excess of—
> (i) the reserve for deferred taxes (as described in section 168(i)(9)(A)(ii) of the Internal Revenue Code of 1986) as of the day before the corporate rate reductions provided in the amendments made by this section take effect, over
> (ii) the amount which would be the balance in such reserve if the amount of such reserve were determined by assuming that the corporate rate reductions provided in this Act were in effect for all prior periods.

Also, it is often the case the information is available to apply the relevant method described in the tax code, but it would take time after the date it becomes available to gather it, analyze it for relevance, format it to be useful, and apply the relevant method to provide a result that would substantiate a tax position to be taken with the IRS.

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Witness: **Linda C. Bridwell**

17. Refer to Kentucky-American's response to Item 1 of the Staff's First Request in which Kentucky American refers to "a one-time land sale." Describe the property that Kentucky-American is referring to therein.

Response:

Kentucky American is referring to 69.58 acres of non-utility property that was part of a larger parcel at Squires Road near Richmond Road in Lexington, sold to Ball Homes, LLC on September 20, 2017.

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Witness: Linda C. Bridwell

18. Provide all supporting schedules, calculations and documentation in Excel spreadsheet format with formulas intact and unprotected, and all rows and columns fully accessible.

Response:

All supporting schedules and documentation in Excel format have been attached to the corresponding discovery requests.