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

Witness: John R. Wilde

8. Refer to the Direct Testimony of John R. Wilde at 4. Given that Kentucky Utilities Company, Louisville Gas and Electric Company, and other utilities were able to calculate the impact the Tax Cuts and Jobs Act has on the excess accumulated deferred income taxes ("ADIT"), explain in detail why Kentucky-American is unable to calculate the impact to its excess ADIT.

Response:

In Mr. Wilde's January 26, 2018 testimony, he states on page 4 that "KAWC will estimate the impact of the re-measurement of ADIT balances in its 2017 financial statements to be finalized later in February, and will need to revise those estimates over the next year as more information becomes available and in preparing 2017 and resolving prior tax returns."

KAW, solely for financial reporting purposes under ASC 740, computed a re-measurement of its ADIT. This estimate was subject to the provisions contained in SEC Staff Accounting Bulletin 118. In SAB 118, SEC staff acknowledges that any amount booked is an estimate subject to change, and as such gives companies a one-year measurement period to make changes. The estimate provided here can and will change within the next year primarily driven mainly by the KAW's parent filing of its income tax returns.

Subject to guidance in SAP 118, KAW re-measured its ADIT. Substantially all of the amount of the re-measurement was recorded in a regulatory liability account reflecting KAW's belief the amounts will be refunded to customers through normalization of the amounts in the future. In the recently filed AWW 10K, KAW recorded a regulatory liability (exclusive of the gross-up) of approximately $32.8 million dollars.

Supplemental Response Dated 08/08/2018:

After further review of the Plant and NonPlant split in deferred taxes, it was determined that the total nonPlant excess deferred taxes was overstated. The total original estimated amount of $32.8 million provided above should be revised to $31.5 million. Please also see the supplemental response to Item 9 of the Public Service Commission's First Discovery Request and the supplemental response with the revised attachment for Item 9 of the Public Service Commission's Second Discovery request.

Witness: John R. Wilde

9. Using Kentucky-American's responses to this Request for Information 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	Net Investment Rate Base			
2	Returns Adjusted For Income Taxes			
3				
4	Required Annual Operating Income Before Taxes (Line 1 x Line 2)	$ -	$ -	$ -
5				
6	Amortization Of Excess ADIT (Protected) - Using Aram			
7	Amortization Of Excess ADIT (Unprotected)			
8				
9	Total Amortization Of Excess ADIT (Line 6 + Line 7)		-	
10	Gross-Up Factor Using 21% Federal Tax Rate			
11				
11	Total Reduction In Deferred Income Tax Expense (Line 9 x Line 10)			-
12				
13	Total Reduction In Revenue Requirements (Line 4 + Line 11)			$ -

If Kentucky-American lacks sufficient information to apply the ARAM method, please instead use the Reverse South Georgia Method to calculate the amortization of excess protected ADIT in Line 6 of the above table. If estimates and assumptions were made to calculate the amounts identified in response to this Request, please identify and describe any estimates and assumptions.

Response:

KAW is not completing the requested template computing a reduction in revenue requirements, because the Company believes it would be imprudent to do so because of the possibility of violating tax normalization rules.

KAW currently lacks the information to develop an estimate for the excess ADIT that could be provided for in the revenue requirements formula. In addition, while the question may contemplate that the necessary offsets in revenue requirements would be addressed pursuant to setting rates, the requested calculation does not provide for the offsetting adjustments to rate base and its effects on revenue requirements that would be required in the context of addressing excess ADIT amounts pursuant to consistency provisions of the tax normalization rules.

KAW, to satisfy the financial accounting rules, has developed a reasonable[1] estimate of the Excess ADIT balances and the offsetting regulatory liability to be booked in accordance with the relevant financial accounting rules so it could produce financial statements as of 12/31/2017. Subsequently, for purposes of discussion, KAW has split that estimate between excess that is related to plant, and not related to plant (non-plant). The reasonable estimated computed and subject to revision is $30,163,661 for plant, and $2,618,551 for non-plant.

Also, for discussion purposes, KAW has developed a reasonable estimate to simulate a amortization period for plant related excess pursuant to RSGM on a total KAW basis. KAW has not made a determination if it will be required to use ARAM, or if it can or should be using RSGM to address the effects of the TCJA. It is unclear at this time to KAW if it can use RSGM, and if it would need to develop estimates specific to water and wastewater plant separately, and further, it would need to develop estimates specific to each wastewater rate jurisdiction.

Companies that have been using ARAM as a method to address prior changes in law are better positioned to split out its estimates between protected and unprotected balances. Companies like KAW that have used RSGM as a method to address prior changes in law do not have a ready method to split its estimates between protected and unprotected excess balances. If a company can isolate its protected Excess ADIT from unprotected Excess ADIT, it likely is required to use ARAM.

Companies that are using ARAM, and are not subject to a consent decree with the IRS to use a normalized method of accounting for tax repairs, will likely have an unprotected plant Excess ADIT balance that might be available to be drawn upon in a rate setting process to avoid a normalization violation if the ARAM calculation used to set rates did not align to a more complete estimate analyzed subsequent to rates being set. KAW changed its method of accounting for repairs subsequent to a consent decree requiring KAW to use a normalized method of accounting for tax repairs.[2] Therefore, KAW's unprotected excess balance is likely an asset or receivable from customers, and not a liability to customers. Thus, greater precision is likely needed for KAW to address its estimate for Excess ADIT in setting rates. It is our estimate that KAW will be able to do this in the first or second quarter of 2019.

---

[1] Securities and Exchange Commission Staff Accounting Bulletin 118,

[2] See the attached 2008 Consent Decree from the IRS requiring the use of a normalized method of accounting to allow KAW to claim tax repairs for plant capitalized for financial accounting purposes.

TCJA as enacted requires the use of ARAM, with an exception that would allow a utility to use RSGM.[3] How to apply the exception with certainty is not yet known. Even though KAW met the exception to use RSGM related to the excess of prior changes in law, each law change requiring an analysis of tax normalization rules must be analyzed and interpreted separately based on the facts and circumstances relevant on and after the date of the law's enactment. While KAW does not have the records in a format and in a system suitable for ARAM, it has the records and systems needed to do ARAM. KAW requires more time to execute such an effort. If KAW uses ARAM it will in effect be using a safe harbor method, and will be using a method that is much more robust in dealing with future changes in tax law. If KAW uses RSGM before it has fully analyzed its ability to do so, it runs the risk that its RSGM estimate will provide a greater amount of Excess ADIT to customers than would be allowed pursuant to ARAM, and would be in violation of the tax normalization rules. The penalties that would accrue to KAW if ordered to do so are two-fold, as outlined in the TCJA.[4]

The delay KAW seeks before beginning to address TCJA related excess ADIT balances in customer rates will provide customers and shareholders the benefit of being highly certain on tax positions related to applying the tax normalization rules. The delay is temporary and there can be a very short catchup period to amortize the amounts deferred during the delay. The time value of the delay is captured in the lower rate base and resulting lower revenue requirement that will occur over the period of delay.

Supplemental Response dated 08/08/2018:

After further review of the Plant and NonPlant split in deferred taxes, it was determined that the estimated total nonPlant excess deferred taxes was overstated. The original estimated amount of $2,618,551 provided above should be changed to $1,384,178. The change is due to a formula issue when re-measuring the deferred taxes related to state charitable contributions, which are not recoverable through rates. See the supplemental response to Item 8 of the PSC's First Discovery Request and the supplemental response to Item 9 of the PSC's Second Discovery Request with a revised attachment in this case as well.

---

[3] TCJA Section 1561(d)(1).
[4] TCJA Section 1561(d)(4).

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.

Supplemental Response Dated 08/08/2018:

b. Please refer to the revised attachment. After further review of the Plant and NonPlant split in deferred taxes, it was determined that the estimated total nonPlant excess deferred taxes was overstated. The original estimated amount of $2,618,551 provided above should be changed to $1,384,178. The change is due to a formula issue when re-measuring the deferred taxes related to state charitable contributions, which are not recoverable through rates. No other information has been revised in this response. Please also note that supplemental responses to Item 8 and Item 9 of the PSC's First Discovery Request have been submitted to reflect this change.