BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS

In the Matter of the Application of Kansas Gas Service, a Division of ONE Gas, Inc. for Adjustment of its Natural Gas Rates in the State of Kansas	))))	Docket No. 18-KGSG-560-RTS

COMMISSION STAFF'S CLOSING BRIEF ON KGS'S DEFERRED REVENUE (TAX REGULATORY LIABILITY)

The technical Staff of the Kansas Corporation Commission (Staff and Commission, respectively), having participated in the evidentiary hearing in this matter, hereby offers the following in closing:

Background and Staff's Position

1. The outstanding issue in this case stems from the passage of the federal Tax Cuts and Jobs Act (TCJA) signed into law by President Trump on December 22, 2017. The TCJA, among other things, reduced the federal corporate income tax rate from 35% to 21%.

2. Rate regulated public utilities in the state of Kansas are ordinarily allowed to collect income taxes from ratepayers as part of their cost of service. Income taxes are referred to as "pass-through" expenses because a utility does not earn a profit on them. Tax expenses are simply collected from ratepayers so that they may be "passed-through" or paid to the taxing entity.

3. The level of tax expense embedded into a utility's cost of service is based upon the expected taxation level at the time its rates are set. With respect to Kansas Gas Service (KGS), this occurred in Docket No. 16-KGSG-491-RTS. The rates established for KGS were based upon a 35% federal corporate income tax.[1] The final rates were approved November 29, 2016.

[1] *See* Application of Kansas Gas Service Continued, p. 148, Section 11-G Page 1 of 1 (May 2, 2016).

4. On January 1, 2018, pursuant to the TCJA, the federal corporate tax rate was dramatically reduced from 35% to 21%.

5. On January 18, 2018, upon a Motion by Staff filed December 14, 2017,[2] the Commission issued an Accounting Authority Order (AAO) in Docket No. 18-GIMX-248-GIV requiring regulated public utilities taxed at the corporate level to track and accumulate, in a deferred revenue account, the effect of the reduced federal corporate income tax on their rates on a single-issue basis based upon their most recent rate case.[3]

6. The parties do not dispute the deferral itself or the amount. For KGS, the amount is approximately $14.1 million annually and it is projected to be approximately $17.9 million on the date the Commission issues its final order in this case.[4]

7. The dispute in this case arises due to Paragraph 11 of the AAO which states in full:

> 11. Second, Staff's recommendation does not contravene existing law regarding the RLECs reasonable opportunity to recover all their costs. Any affected utility that believes that other components of their cost of service have more than offset the decrease in its income tax expenses will have the ability to file such information and supporting data with the Commission, to be considered on a case-by-case basis. The Commission's intention here is not to materially impact regulated utilities' profitability, but rather, ensure that the affected utilities are neither positively nor negatively impacted by the passage of federal income tax reform. The Commission finds Staff's recommendation is in keeping with the Commission's statutory obligation to ensure just and reasonable rates29 and an appropriate review of KUSF support.30 Likewise, the Commission finds Staffs recommended approach does not deprive any party of due process but rather protects potential ratepayer benefits from being lost during the pendency of the Commission's

[2] Staff's Motion to Open General Investigation and Issue Accounting Authority Order Regarding Federal Tax Reform (Dec. 14, 2017) (Staff's AAO Motion).

[3] *See* Order Opening General Investigation and Issuing Accounting Authority Order Regarding Federal Tax Reform, Docket No. 18-GIMX-248-GIV, p. 5 (Jan. 18, 2018) (AAO).

[4] *See* Order Granting Joint Motion for Approval of Settlement Agreement Regarding Kansas Gas Service, Summary (May 15, 2018); Direct Testimony of Janet Buchanan, p. 27 (June 29, 2018) (Buchanan Direct); Tr. p. 56 (Buchanan).

> investigation. Therefore, the Commission adopts Staffs R&R and incorporates it herein.

8. KGS believes the second sentence in Paragraph 11 compels the Commission to let KGS write-off the entire $17.9 million in deferred revenue because KGS has demonstrated it is currently under-earning its revenue requirement by greater than $17.9 million.[5] KGS's exact level of under-earning for 2018 and beyond cannot be precisely calculated in this case because KGS's test year for its immediate rate case ended December 31, 2017.[6] However, KGS argues the $19.8 million revenue deficiency advocated by Staff in its Direct Testimony is reflective of KGS's under-earnings for 2018.[7]

9. Staff's closing brief will argue that the "case-by-case" language from Paragraph 11 of the AAO relied upon by KGS should not be read in a way that nullifies the intent of the AAO. KGS nullifies the intent of the AAO by redefining the term "profitability." The third sentence of Paragraph 11 makes clear that the purpose of the AAO is to ensure affected utilities are neither positively nor negatively impacted by the passage of the TCJA. Allowing KGS to write-off the deferred revenue would positively impact KGS and contravene this clearly stated intent. Finally, even if one assumes KGS has shown offsetting costs, the AAO does not compel a particular outcome and determination of the issue should be guided by the statutory "just and reasonable" standard. It is not "just and reasonable" to let KGS write off the tax regulatory liability.

Argument

A. The purpose of the "case-by-case" sentence in Paragraph 11 is to provide companies with due process and show directly offsetting costs, but not nullify the overall intent behind the AAO.

[5] *See* Rebuttal Testimony of Janet Buchanan, p. 11 (Nov. 19, 2018) (Buchanan Rebuttal).
[6] *See* Id.
[7] *See* Id.

10. The "case-by-case" sentence contained in Paragraph 11 of the AAO is in immediate response to a challenge by the Rural Local Exchange Carriers (RLECs) about the legality of the AAO. The RLECs filed an opposition to Staff's Motion for the AAO on January 2, 2018, alleging the proposed AAO could contravene existing law regarding the reasonable opportunity of rural telephone companies to recover all costs, by affecting certain otherwise-available revenues without full consideration of all recoverable costs and all other sources of revenue.[8]

11. In Paragraph 11 of the AAO, the Commission responded to this challenge by explaining the AAO would not contravene existing law regarding the RLECs reasonable opportunity to recover all their costs because "any affected utility that believes that other components of their cost of service have more than offset the decrease in its income tax expenses will have the ability to file such information and supporting data with the Commission, to be considered on a case-by-case basis."

12. Justin Grady explained during the evidentiary hearing that the language was lifted from his Report and Recommendation and refers to the "preservation of due process" and the ability of a utility show "direct offsetting impacts associated with tax reform."[9]

13. As an example of Staff's interpretation in practice, when Staff met with the RLECs regarding their calculation of the deferred revenue, the RLECs presented Staff with evidence that tax expense imbedded in their KUSF support was also directly related to their calculation of Federal High Cost Loop support such that it had to be considered an offsetting cost. Staff agreed with the argument and this was noted in Staff testimony supporting several of the Settlement

[8]*See* Response to Motions by Staff and CURB, p. 2 (Jan. 2, 2018) (RLECs Response).
[9]Tr. p. 67 (Grady).

Agreements with the RLECs.[10] Staff, however, does not agree that the language refers to an entire revenue requirement deficiency being used as an offsetting cost. The language specifically refers to "components" of cost of service. Staff found that the RLECs specifically identified components directly related to the calculation of the deferred revenue whereas KGS has not.

14. Staff's interpretation aside, the main problem with KGS's interpretation of the language is that it effectively nullifies the third sentence of Paragraph 11 regarding the intent behind the AAO. This is because allowing KGS to write-off the $17.9 million tax regulatory liability would materially impact its profitability and positively impact KGS. As Justin Grady explained in his testimony, because the deferred revenue reflects dollars collected from ratepayers to which no associated expense exists, allowing KGS to keep it would result in an increase in profitability to KGS.[11]

15. KGS tries to get around this argument by presenting an unusual definition of the word "profitability" to show that it is not positively impacted. However, as will be explained below, this redefinition is inconsistent with plain English.

B. KGS's definition of the word "profitability" is inconsistent with plain English

16. There is no way to harmonize KGS' interpretation of Paragraph 11 without presenting an untenable definition of "profitability." The best way to harmonize the language of Paragraph 11 is to utilize the plain English definition of profit/profitability, and: 1) find that KGS has failed to show offsetting cost components consistent with sentence two of Paragraph 11; 2) find that writing off the deferred tax liability would positively impact KGS and violate the intent behind the AAO; or 3) consider the evidence presented on a case-by-case basis but find that it

[10] *See* Testimony in Support of Wamego Settlement Agreement Prepared by Justin T. Grady, p. 10, Docket No. 18-GIMX-248-GIV (Nov. 5, 2018); Testimony in Support of JBN Settlement Agreement Prepared by Justin T. Grady, p. 9, Docket No. 18-GIMX-248-GIV (Nov. 6, 2018).
[11] *See* Direct Testimony of Justin T. Grady, p. 27 (Oct. 29, 2018) (Grady Direct).

would not be "just and reasonable" in this case to allow KGS to write off the deferred revenue. All of these outcomes would ensure the Commission's stated intent is being followed without re-defining profit/profitability.

17. According to KGS, "profit" under Paragraph 11 alludes to dollars earned above KGS' authorized revenue requirement; meaning, unless KGS is currently earning above its authorized revenue requirement, the writing off of the $17.9 tax regulatory liability would not be a "profit." By interpreting "profit" in this manner, KGS is attempting to attach a convoluted definition to a straightforward concept.

18. "Profit," and/or "profitability" as used in the AAO means an increase in net income.[12] As explained above, the tax regulatory liability reflects dollars collected from ratepayers to which no associated expense exists. As such, writing off the tax regulatory liability represents an increase in net income for KGS.[13] It is only by requiring KGS to refund the tax regulatory liability that its profitability can be left unchanged under a plain English understanding of the word. In other words, only by requiring KGS to refund the tax regulatory liability can the Commission comply with the AAO's stated intent.

C. The AAO does not compel a particular outcome, so determination of this issue should be governed by the statutory "just and reasonable" standard.

19. Even assuming, *arguendo*, that KGS's interpretation is correct and it has proven it has offsetting costs consistent with Paragraph 11, the language does not compel a particular outcome. The language simply states that the information can be filed and considered on a case-by-case basis.

[12] *See generally* https://www.merriam-webster.com/dictionary/profit definition 3.
[13] *See* Tr. p. 57 (Buchanan).

20. No specific standards for case-by-case consideration are provided in the AAO. Therefore, determination of the issue would be based upon the statutory "just and reasonable" standard.[14]

21. The $17.9 million tax regulatory liability represents over-collections of tax expense from ratepayers that KGS will not actually owe to the IRS. In other words, KGS has been charging customers for an expense that it will not actually incur. It is not "just and reasonable" to allow KGS to retain this money because it would constitute a windfall to shareholders at the expense of ratepayers. The reasoning is explained by Justin Grady in his Direct Testimony:

> **Justin Grady:** There are several reasons why Staff contends [requiring KGS to refund the entire $17.9 tax regulatory liability] is the right decision. First, the only way to ensure that the deferred tax savings do not inure to the benefit of KGS's shareholders is to credit all of the tax benefits to KGS customers. Otherwise, when KGS's tax liability dramatically declined on January 1, 2018, the benefit of that reduction in income tax expense would flow directly to KGS's shareholders. Whether the result was that KGS would be earning more or less than its authorized return, it is irrefutable that the result of allowing KGS to keep the deferred tax savings would be an increase in KGS's profitability starting on January 1, 2018. That would be directly contrary to the Commission's stated purpose behind issuing the AAO, as quoted above by Ms. Buchanan. The Commission stated in that referenced passage in the Order: "The Commission's intention here is not to materially impact regulated utilities' profitability, but rather, ensure that the affected utilities are neither positively nor negatively impacted by the passage of federal income tax reform." Because KGS's income tax expense went down on January 1, 2018, if 100% of the deferred tax savings are given to customers in the form of a bill credit, the result is that KGS will not be positively or negatively impacted by the passage of federal income tax reform, just as the Commission intended.[15]

[14]*See* K.S.A. 66-1,202.
[15]Grady Direct at 27-28.

22. Justin Grady also explained in his Direct Testimony that customers should receive the benefits of tax reform just as KGS is routinely provided benefits on a single-issue basis.[16] He stated the following:

> **Justin Grady:** Another consideration that should influence the Commission is all of the ways in which KGS shareholders are already insulated from the risks associated with extraordinary or material changes to expenses or revenues that are outside of KGS' control. As a regulated utility, KGS is protected from many of the risks and potential perils of a business that faces unregulated competition. Customers are often asked to makes KGS whole when circumstances arise that result in a significant negative financial event for KGS, especially if that event is outside of the control of KGS and results in a material or extraordinary expense. In these circumstances the Commission often utilizes deferral accounting mechanisms (a regulatory asset or regulatory liability) to capture the financial effect of the event and transfer that financial effect to ratepayers in a future rate case. Examples include the Cyber Security Tracker KGS has requested in this Docket, the Pension Tracker, the Cost of Gas Rider (COGR), the Bad Debt Expense component of the COGR, and the deferral mechanism established in the 17-455 Docket to account for and capture environmental expenditures associated with manufactured gas plant sites owned by KGS predecessor companies. In effect, each of these deferral accounting mechanisms utilize single-issue ratemaking to isolate the expenses in question, insulate KGS from the financial effects of the event, and transfer the financial effects of the event to ratepayers in some future forum. Staff is requesting that the Commission treat the positive financial impact of the TCJA in the same fashion, that is, the full impact of this event should be isolated and captured in a regulatory liability on a single-issue basis and that regulatory liability should be given back to customers without any offsets or mitigating factors.[17]

23. Out of fairness to ratepayers who are routinely called upon to make KGS whole, the Commission should give similar single-issue treatment to this tax issue and require a refund to ratepayers.

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[16]*See* Id. at 28.
[17]Id. at 28-29.

WHEREFORE, for the reasons set forth above, Staff respectfully requests that the Commission require KGS to refund the regulatory tax liability to its customers consistent with the methodology provided in the Direct Testimony of Robert Glass dated October 29, 2018, pages 22-24.

Respectfully submitted,

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VERIFICATION

Michael Neeley, being duly sworn upon his oath deposes and states that he is Litigation Counsel for the State Corporation Commission of the State of Kansas, that he has read and is familiar with the foregoing *Commission Staff's Closing Brief on KGS'S Deferred Revenue (Tax Regulatory Liability)* and that the statements contained therein are true and correct to the best of his knowledge, information and belief.

Michael Neeley # 25027
Kansas Corporation Commission of the State of Kansas

Subscribed and sworn to before me this 16th day of January, 2019.

VICKI D. JACOBSEN
Notary Public - State of Kansas
My Appt. Expires 6-30-22

Notary Public

My Appointment Expires: June 30, 2022

CERTIFICATE OF SERVICE

18-KGSG-560-RTS

I, the undersigned, certify that a true and correct copy of the above and foregoing Commission Staff's Closing Brief on KGS's Deferred Revenue (Tax Regulatory Liability) was served via electronic service this16th day of January, 2019, to the following:

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