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May 24, 2022

BY E-FILING

Mr. Adam Teitzman, Clerk
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

Re: **Docket No. 20220067-GU: Petition for rate increase by Florida Public Utilities Company, Florida Division of Chesapeake Utilities Corporation, Florida Public Utilities Company - Fort Meade, and Florida Public Utilities Company - Indiantown Division.**

Dear Mr. Teitzman:

Attached, for electronic filing, please find the Testimony of Mike Reno.

Thank you for your assistance with this filing. As always, please don't hesitate to let me know if you have any questions whatsoever.

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Sincerely,

Beth Keating
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BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

FLORIDA PUBLIC UTILITIES COMPANY

Docket No. 20220067-GU

Direct Testimony

of

Michael J. Reno,
Ernst & Young, LLP

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND POSITION.

A. My name is Michael Reno. I am a managing director in Ernst & Young LLP's National Energy Practice. My business address is 1101 New York Avenue, NW, Washington, District of Columbia, 20005-4213.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. I am testifying on behalf of Florida Public Utilities Company.

Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?

A. I graduated from Kansas State University in 1987 with a Bachelor of Science degree in Business Administration, with an emphasis in accounting, and a Master of Science in 1988, with an emphasis in accounting. After completion of my Master of Science in Accounting, I joined Deloitte Tax LLP, formerly Deloitte Haskins & Sells. In 2012, I joined Ernst & Young LLP as an executive director in the National Energy Practice. I am a Certified Public Accountant, licensed in the District of Columbia and in the Commonwealth of Virginia. I have practiced public accounting for over 32 years. In my practice, I provide tax services to regulated water, electric and gas utilities. I regularly assist clients with tax planning, support and explain tax reporting positions, and perform tax return reviews. My experience includes providing advice on accounting for income taxes and performing tax provision reviews. I also regularly consult with companies regarding tax accounting and its impact on the rate setting process as well as compliance with the normalization rules. Additionally, I am a frequent speaker at industry seminars and conferences on the topic of tax accounting for rate-regulated utilities. I have spoken at the Edison Electric Institute tax committee meetings and the American Gas Association tax committee meetings in addition to other industry meetings.

Q. HAVE YOU TESTIFIED IN ANY REGULATORY PROCEEDINGS?

A. Yes, I have testified on tax, tax accounting and regulatory tax matters before the Florida Public Service Commission, New Jersey Board of Public Utilities, the California Public Utilities Commission, the Connecticut Public Utilities Regulatory Authority, Michigan Public Service Commission, and the Federal Energy Regulatory Commission.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony is to explain how the accumulated deferred income tax ("ADIT") balances included as a component of Florida Public Utilities' capital structure for the purposes of its general rate case filing comply with the normalization method of accounting as defined in Internal Revenue Code "IRC" 168(i)(9). I will also provide support for the calculation of income tax expense included as a component of Florida Public Utilities Company's cost of service.

III. THE NORMALIZATION METHOD OF ACCOUNTING

Q. CAN YOU PLEASE PROVIDE BACKGROUND ON WHAT TRIGGERS AN ADIT BALANCE ON THE BOOKS AND RECORDS OF A REGULATED COMPANY?

A. ADIT arises from timing differences between the method of computing taxable income for reporting to the IRS and the method of computing income for regulatory accounting and ratemaking purposes. Generally, ADIT represents the accumulation of deferred tax liabilities recorded on the balance sheet that captures the tax amount attributable to temporary differences, driven by the different income recognition requirements for tax reporting purposes and for financial statement or book accounting purposes.

Q. WHY DOES CONGRESS REQUIRE A PUBLIC UTILITY TO USE THE NORMALIZATION METHOD OF ACCOUNTING?

A. In 1954, Congress enacted a new tax law that provided for accelerated depreciation. The primary motive behind the introduction of accelerated depreciation was to provide a permanent investment incentive to business taxpayers. Because federal income tax expense is included in a utility's cost of service for ratemaking purposes, some regulatory agencies reduced the federal tax expense included in cost of service to reflect the reduction in a utility's tax liability caused by accelerated depreciation, i.e., some regulators "flowed through" the tax benefit associated with accelerated depreciation to ratepayers. As a result, the accelerated depreciation became a massive federal utility subsidy to ratepayers as opposed to an investment incentive for the utility. Moreover, the flow through of the benefits of accelerated depreciation to ratepayers resulted in a loss of federal income tax revenues because the flow-through reduced utility profits. To ensure that accelerated depreciation achieved its stated purpose, Congress enacted the normalization rules in 1969, which permit a utility to claim accelerated depreciation only if the utility complies with the normalization rules.

Q. DOES CONGRESS MANDATE THE USE OF THE NORMALIZATION METHOD OF ACCOUNTING?

A. Yes, IRC Sec. 168(f)(2) provides that "public utility property" does not qualify for accelerated depreciation if the taxpayer does not use a "normalization method of accounting." IRC Sec. 168(i)(10) defines "public utility property" as including property used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system, and the transportation of gas by pipeline if a public utility commission or other similar body establishes the rates for such furnishing or sale. Therefore, while the Internal Revenue Code does not mandate any particular rate treatment, it does limit the ability to use accelerated depreciation unless the utility uses the normalization method of accounting.

Q. CAN YOU DEFINE THE NORMALIZATION METHOD OF ACCOUNTING?

A. Yes, IRC Sec. 168(i)(9) defines the general requirements a taxpayer must meet to be considered as using the normalization method of accounting. First, the taxpayer must use (i) the same method of depreciation to compute both its tax expense and its depreciation expense to establish its cost of service for ratemaking purposes and to reflect operating results in its regulated books of accounting, and (ii) a recovery period that is no shorter than the useful life is used in determining depreciation for ratemaking purposes. Second, the difference between the actual tax expense computed using tax depreciation and the tax expense determined for ratemaking purposes must be reflected in a deferred tax reserve. Third, in determining the rate of return of a public utility, the public utility commission may not exclude from the rate base an amount that exceeds the addition to the deferred tax reserve for the period used in determining the tax expense for ratemaking purposes. Fourth, the utility may not use an "inconsistent" procedure or adjustment. A procedure or adjustment is "inconsistent" if it employs an estimate or projection with respect to a utility's (i) tax expense, (ii) depreciation expense, or (iii) reserve for deferred taxes, unless such estimate or projection is also used with respect to the other two items and rate base. If a taxpayer fails to satisfy any one of these requirements, it ceases to qualify for accelerated depreciation, and must compute depreciation using the straight-line method over the asset's regulatory life.

Q. HOW DOES THE NORMALIZATION METHOD OF ACCOUNTING APPLY IN THE RATEMAKING CONTEXT?

A. A utility's federal income tax expense is an element of the utility's cost of service. The first requirement of the normalization rules requires the utility to calculate the federal income tax expense included in its cost of service using the same method of depreciation it uses for financial statement purposes, i.e. straight-line depreciation.

The difference between the utility's actual federal income tax expense and the federal income tax expense included in its cost of service related to the use of accelerated depreciation for federal income tax purposes is tracked in a deferred income tax reserve account, commonly referred to as an ADIT account. Typically, the use of accelerated depreciation results in a deferred income tax expense and a corresponding deferred income tax liability, i.e., the current federal income tax payable is less than the total federal income tax expense included in cost of service, which includes both current and deferred income taxes. The deferred tax expense associated with accelerated depreciation is equivalent to an interest free-loan from the Internal Revenue Service. Because a utility is not permitted to earn a rate of return on cost-free capital, the deferred tax liability reduces the utility's rate base or is included as zero-cost capital within the capital structure.

Q. DOES THE IRS REQUIRE THE USE OF A SPECIFIC METHOD UNDER THE NORMALIZATION RULES TO DETERMINE THE ADIT BALANCE THAT SHOULD BE EXCLUDED FROM RATE BASE?

Treasury Reg. Sec. 1.167-1(h)(6)(ii) provides the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base (i.e.., as no-cost capital). Section 1.167(l)-1(h)(6)(ii) provides if, in determining depreciation for ratemaking tax expense, a period (the "test period") is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period.

The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period. This is generally referred to as "the proration formula" or the "proration methodology."

IV. THE APPLICATION OF THE PRORATION ADJUSTMENT TO FLORIDA PUBLIC UTILITIES COMPANY'S ADIT BALANCES FOR THE PURPOSES OF CALCULATING ITS RATE BASE

Q. CAN YOU DESCRIBE THE NATURE OF FLORIDA PUBLIC UTILITIES COMPANY'S ADIT BALANCES?

A. As mentioned previously, timing differences between the recognition of items of income or expense for tax purposes versus financial statement accounting purposes results in either a deferred tax asset or a deferred tax liability balance. Accelerated or bonus depreciation is the most common example of a temporary difference that generates a deferred tax liability. When accelerated depreciation is claimed by a taxpayer, the depreciation expense deduction during the beginning of the assets useful life is much larger than it is for financial statement reporting purposes. Because the recognition of this expense is only an issue of timing and not amount, this difference will eventually reverse over the course of the asset's useful life, and the deferred tax liability will be reduced accordingly. Alternatively, there are also instances where an expense is recognized for financial statement or book reporting purposes but is not fully allowed as a deduction for income tax purposes, resulting in a deferred tax asset. The requirement that overhead expenses be capitalized to items of inventory and deducted as a cost of goods sold once inventory is sold or consumed for income tax purposes but not for financial statement reporting provides an example of a timing difference that results in a deferred tax asset.

Florida Public Utilities Company's largest deferred income tax expense item is attributable to what is referred to as "state decoupling." This occurs when a state does not conform to certain federal tax provisions, and net income used to calculate the state income tax differs from both the income reported for financial statement purposes and the income reported for federal tax purposes as a result. The other primary driver of Florida Public Utilities Company's ADIT balance is the temporary difference, or deferred income tax expense, stemming from its recognition of tax depreciation versus depreciation expense for financial statement accounting purposes. MFR Schedule C-24 provides a complete listing of the deferred income tax expense items recognized by Florida Public Utilities Company during the historical base year. Each of these items contributes to the ADIT balances included on MFR Schedule B-18.

Q. WERE THERE ANY ADJUSTMENTS TO THE HISTORIC TEST PERIOD AMOUNTS TO ARRIVE AT THE PROJECTED TEST PERIOD AMOUNTS INCLUDED IN FLORIDA PUBLIC UTILITIES COMPANY'S ADIT BALANCES?

A. MFR Schedule C-24 provides the detail related to the historic base year deferred tax expense total, listing each item that contributes to the total timing difference between net income for book purposes and net income for tax purposes. MFR Schedule G-2 provides the same for the historic base year +1 (i.e. year ending 12/31/2022) and the projected test year (i.e. year ending 12/31/2023). As reflected in these schedules, the timing differences are consistent in amount from the historic base year through the projected test year for each item, with the exception of the depreciation timing difference, included on each of the schedules under Line 3, and the "Deferred Only Adjustment" reflected on Line 28. The amount attributable to both of these timing differences is appropriately updated in the future and projected test periods based on the information reasonably available at the time of this rate case filing.

Q. CAN YOU DESCRIBE THE NATURE OF THESE ADJUSTMENTS, AND HOW THE AMOUNTS WERE DETERMINED?

A. The adjustment to the timing difference stemming from accelerated depreciation for both the historic base year +1 and the projected test year is driven by projected depreciation on existing assets for both book and tax purposes and estimates related to planned or expected purchases and anticipated retirements during each of these periods. Using this information, Florida Public Utilities Company's calculated the total projected tax and book depreciation for the projected and future periods and included the difference in the deferred tax expense total for each year accordingly, as reflected on MFR Schedule G-2.

Outside of the adjustment related to accelerated depreciation, the "Deferred Only Adjustment" included MFR Schedule G-2, Line 28 was also updated for the future test periods. This deferred tax expense item includes the yearly amortization of the deferred tax liability recorded as part of the Florida Public Utilities Company acquisition adjustment in accordance with Florida Public Service Commission Order No. PSC-12-0010-PAA-GU, and the deferred tax expense associated with the amortization of both the protected excess ADIT (i.e. subject to the normalization rules and properly amortized using the average rate of assumption method) and the unprotected excess ADIT resulting from the statutory rate change enacted as part of the federal Tax Cuts and Jobs Act ("TCJA"). Because these totals for the future test periods are known at the time of this rate case filing, they are properly adjusted to reflect the projected deferred tax expense totals for the future test periods.

Q. HOW DOES THE PRORATION REQUIREMENT IMPACT FLORIDA PUBLIC UTILITIES COMPANY'S CAPITAL STRUCTURE FOR THE PROJECTED TEST PERIODS?

A. Florida Public Utilities Company calculated the proration requirement for the test year ending 12/31/2023, and then compared the prorated ADIT balances to the 13-month average ADIT balances per book. The result in both cases was a weighted average cost of capital totaling 6.43%. Because the proration adjustment did not yield a change to Florida Public Utilities' capital structure, it was not included in the MFR schedules as part of this rate case filing.

V. <u>THE CALCULATION OF INCOME TAX EXPENSE INCLUDED IN FLORIDA PUBLIC UTILITIES COMPANY'S COST OF SERVICE</u>

Q. HOW DID FLORIDA PUBLIC UTILITIES COMPANY CALCULATE THE PROJECTED INCOME TAX EXPENSE?

A. Florida Public Utilities Company used the historical timing differences between the recognition of items of income or expense for book purposes and tax purposes to estimate the timing differences for the projected test years. The projected net income before income taxes and interest expense, less the interest expense calculated on the cost of capital projections, adjusted for the anticipated timing differences was multiplied by the effective tax rate to arrive at the total current tax expense.

Q. HOW WAS THE EFFECTIVE TAX RATE USED TO CALCULATE PROJECTED INCOME TAX EXPENSE DETERMINED?

A. Florida Public Utilities Company uses an effective tax rate of 25.35%, which accounts for both the applicable federal and state tax rates, which are 21% and 5.5%, respectively. MFR Schedule G-2 provides specific details related to the calculation of both state and federal income tax expense for the projected periods.

Q. WERE THERE ANY ADJUSTMENTS INCLUDED IN THE TAX EXPENSE CALCULATION FOR PERMANENT DIFFERENCES BETWEEN BOOK INCOME AND TAX INCOME?

A. As detailed on MFR Schedule C-23, Florida Public Utilities Company adjusted its federal taxable income for the historic base year ending 12/31/2021, the historic base year +1 ending 12/31/2022, and the projected test year ending 12/31/2023 to account for book expense items that are not deductible for tax purposes, otherwise known as permanent differences. These permanent items were consistent across each of the three periods.

Q. WERE ANY OTHER ADJUSTMENTS INCLUDED IN THE TAX EXPENSE CALCULATION?

A. Yes. As part of the TCJA, the corporate income tax rate was reduced from 34% to 21%. Because the ADIT reserves, which represent a future obligation to pay a future tax liability, are determined and recorded based on the tax rate in effect at the time the reserve balance is generated, the tax rate reduction resulted in the ADIT balances being overstated by 13%. This excess ADIT resulting from the corporate tax rate decrease can be broken out into two categories, protected and unprotected. “Protected” excess ADIT stems from accelerated depreciation deferred tax balances, and the application of the prescribed normalization method to reduce and return the excess ADIT back to customers when computing cost of service for ratemaking purposes is required. Alternatively, unprotected excess ADIT is not required to be normalized, and can be amortized over any period sanctioned by the applicable regulators.

As it relates to the protected portion of excess ADIT, the normalization method of accounting requires the use of the average rate of assumption method (“ARAM”) in order to reduce the excess tax reserves in computing the cost of service for ratemaking purposes. Under ARAM, the excess ADIT related to public utility property will be amortized over the remaining life of the property at a rate that follows the reversal of the deferred tax.

The unprotected portion of Florida Public Utilities Company's excess ADIT is properly amortized over a period of ten years, as approved by the Florida Public Service Commission in Final Order No. PSC-2019-0076-FOF-GU, issued February 25, 2019, in Docket No. 20180051-GU (Florida Public Utilities Company – Indiantown and Florida Public Utilities Company – Fort Meade are separate divisions of FPUC. Docket Nos. 20180052-GU, 20180053-GU and 20180054-GU were opened to address the tax impacts affecting FPUC – Indiantown, FPUC – Fort Meade, and Chesapeake, respectively).

Schedule MFR C-18 provides detail related to the historic base year amortization of the protected and unprotected portions of Florida Public Utilities Company's excess ADIT stemming from the statutory change in tax rates. This amortization expense is accounted for in Florida Public Utilities Company's pretax income and returned to customers accordingly utilizing the average rate of assumption method for the protected portion, and the 10-year period, consistent with the Florida Public Service Commission's Final Order referenced above, for the unprotected portion.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.