NEW YORK AMERICAN WATER

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VIA ELECTRONIC FILING

Hon. Kathleen H. Burgess
Secretary
New York State Public Service Commission
Three Empire State Plaza
Albany, New York 12223-1350

CASE 17-M-0815 - Proceeding on Motion of the Commission on Changes in Law that May Affect Rates

Dear Secretary Burgess:

New York American Water Company, Inc. ("NYAW" or the "Company") hereby submits this letter in lieu of more formal comments in response to the Notice Soliciting Comments on Staff Proposal issued on June 11, 2018, in the above-referenced proceeding.

I. Introduction

New York American Water Company was deemed a Qualified New York Manufacturer ("QNYM") at the time its most recent rate plan was approved in May 2017. As a QNYM the Company's state corporate income tax rate was zero percent. However, the state income tax law, effective January 1, 2018, changed the definition of QNYM and consequently changed the effective state income tax rate for the Company as of that date from 0% to 8.36% (inclusive of the MTA charge). The NY Public Service Commission ("NYPSC") subsequently initiated Case 17-W-0232 to determine the implications of this change on the Company and examine the ratemaking options to reflect this change. The Company submitted testimony and exhibits in September 2017 so the New York Department of Public Service Staff ("DPS Staff") could review the impacts of the state tax rate change on the company's rate plan. DPS Staff propounded discovery on the information submitted by the Company.

On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA" or "Tax Act") was signed into law. The TCJA, among other provisions, changed the federal corporate income tax rate from 35% to 21% effective January 1, 2018. The NYPSC initiated Case 17-M-0815 on December 29, 2017 to study the potential effects of the Tax Act on New York's regulated utilities. In January 2018, DPS Staff issued a request for information to the utilities, and, in February 2018, held a technical conference to discuss the Tax Act. The Company responded to the request for information in March 2018. On March 29, 2018, the DPS Staff issued their Staff Proposal to Address the Accounting and Ratemaking of the Tax Cuts and Jobs Act of 2017 ("Staff Proposal"). The Staff Proposal indicated that for companies included in Case 17-W-0232, the net impacts of the changes in state income tax and federal income tax be addressed on a consolidated basis in Case 17-W-0232. (Staff Proposal at 42 n.42.) The Staff Proposal also required companies to provide comments on DPS Staff's recommended accounting and ratemaking treatment of the Act's impacts within 90 days of the issuance of the Staff Proposal. The following are NYAW's comments regarding Staff's Proposal for TCJA implications, in conjunction with the effects of the change in state income tax rate.

II. Implications of QNYM and TCJA on NYAW Rate Plan

In Case 16-W-0259, the NYPSC approved a four-year rate plan for NYAW, covering the period April 1, 2017 to March 31, 2021. The annual revenue requirements in the rate plan included federal income tax ("FIT") at a 35% tax rate, and state income tax ("SIT") at a 0% tax rate. The Company was authorized recovery of a capital base tax, which is paid in lieu of SIT, of $115,334 and $75,175 for each of the four rate years for Service Area 1 (“SA-1”) and Service Area 2 (“SA-2”), respectively. As the Company was subject to a 0% SIT rate as a QNYM as of January 1, 2014, it reclassified its accumulated deferred SIT to a Regulatory Liability and booked any over-recovery of SIT expense in rates to the Regulatory Liability to be returned to customers. In Case 16-W-0259, the NYPSC approved a three-year amortization in the revenue requirement to return the Regulatory Liability to customers. Similarly, since January 1, 2018, the Company has deferred to a Regulatory Asset the under-recovery of SIT expense in rates, and deferred to a Regulatory Liability the over-recovery of FIT expense in rates. These deferrals will continue until the Company’s tariff rates reflect a revenue requirement that utilizes an 8.36% SIT rate and 21% FIT rate.

III. Re-establishment of Deferred State Income Taxes

As of January 1, 2018, the Company calculated an estimate of its re-measured state deferred taxes of $11.5m. While the tax deficiency itself is $11.5m, the regulatory liability was recorded at a grossed up amount of $15.8m. The deficient deferred income taxes are grossed up because the company is required to record regulatory assets and liabilities at their pre-tax amount. As the deficient deferred taxes amortize, they create a revenue requirement that is grossed up. The grossed up revenues will be subject to tax and in the end, recovery of the deficiency net of tax will offset the amortization of the deficiency of $11.5m. These amounts are estimates and expected to change after the 2017 tax return is filed later in the year and the deferred balances are trued up to the tax return. See the discussion below under Section IV. Remeasurement of Deferred Federal Income Taxes for more on the timing and status of the calculation.

The amortization of the regulatory asset related to the state rate change is not governed by the IRS normalization rules. Therefore, the period of amortization is to be determined through discussions with the Commission. It is the Company's proposal that amortization of the deficient deferred state income taxes should be offset with the amortization of the excess federal deferred tax liability, minimizing the impact of the two rate changes. See the discussion below under Section V. Recommendation for Ratemaking Treatment.

IV. Remeasurement of Deferred Federal Income Taxes

As of January 1, 2018, the Company calculated an estimate of its remeasured federal deferred taxes of $36.4m. That balance needs to be grossed up for taxes for the same reasons as the state regulatory asset. The grossed up regulatory liability is $50.3m. Similar to the state remeasurement, these amounts are estimates and expected to change after the 2017 tax return is filed later in the year and the deferred balances are trued up to the tax return.

For the federal remeasurement, the Company must follow the IRS normalization rules related to plant (specifically life and method differences generating the deferred taxes). This difference is often referred to as the protected excess. The IRS normalization rules do not apply to non-plant items.

The Company cannot pass any excess accumulated deferred income taxes ("ADIT") to customers before it has determined its protected and unprotected excess ADIT balances and the appropriate amortization amounts pursuant to the average rate assumption method ("ARAM"). Returning any portion of the Company's excess ADIT before determining what is protected and what is unprotected pursuant to ARAM would risk a normalization violation and loss of accelerated depreciation, to the detriment of both the Company and its customers. Customers benefit from the Company's use of accelerated tax depreciation because the resulting ADIT is a reduction to rate base and provides a source of funds for infrastructure investment. If the Company returns excess ADIT to customers for protected temporary differences more rapidly than ARAM would permit, the Company could lose its ability to utilize accelerated tax depreciation.

Currently, the company has not finalized building the records needed for an ARAM computation, nor has it set up its existing systems to process ADIT balances pursuant to ARAM. The Company is working expeditiously to implement the necessary computer software changes to compute ARAM. These changes include formatting vintage deferred tax records into a data structure which American Water's tax accounting software can utilize to compute ADIT balances and normalize amortization periods pursuant to ARAM. This is a complicated and laborious process, which we estimate will not be completed until the end of the first quarter of 2019. The system to calculate ARAM was not built prior to this time because the Company was using the Reverse South Georgia Method (RSGM). This is an alternative method provided by the IRS that a company can use if it does not have the necessary records to calculate ARAM. It is NYAW's belief that currently it does have the ability and systems to build the records and perform the computations, and therefore is unable to use RSGM going forward.

Since the unprotected excess is not guided by IRS rules, once the protected and unprotected amounts are determined, a reasonable calculation can be agreed upon with the Commission. The Company currently is proposing to use ARAM for the unprotected excess as well.

While the Company does not propose to credit customers with the net (federal offset with state) excess ADIT until the next rate case, the company does not believe it is appropriate to compute interest on the deferred amounts. This is because the excess ADIT reduces rate base and thus the Company's return. Until the credits for excess ADIT begin flowing, and the company accounts for the rate base implications of the credits, the customers will continue to enjoy the reduced return the excess creates. To add interest on top of these amounts would be inappropriate.

V. Recommendation for Ratemaking Treatment

Cash Flow Considerations

As DPS Staff rightly emphasizes on page 33 of the Staff Proposal, "for utilities, the cash flow ramifications from some of the Tax act's provisions are largely viewed negatively my major ratings agencies." Moody's Investor Service ("Moody's") identified 24 regulated utilities in January 2018 that were put on a "negative credit watch" due to the Tax Act, including American Water Works Company, Inc., the parent company of NYAW. The Staff Proposal quotes Moody's, S&P Global, and Fitch Ratings as looking to regulators to potentially provide relief to utilities for the negative cash flow impacts from the Tax Act.

NYAW's rate plan revenue requirements included investment of $161.4 million in infrastructure, for which the revenue requirement impact of any accumulated shortfall of investment would be returned to ratepayers (JP, page 7). Indeed, these capital investment expectations were utilized in the Company's recent petition for issuance of long-term debt in Case 17-W-0618. With the new expectation of slower growth in accumulated deferred FIT ("ADFIT"), only somewhat offset by expected growth in accumulated deferred SIT ("ADSIT).

Recommendation for Over-Recovery of FIT Expense and Under-Recovery of SIT Expense

The Company proposes to use the excess ADIT regulatory liability flowback first as an offset against the ADSIT regulatory asset until such time the ADSIT regulatory asset is eliminated. Once the ADSIT regulatory asset is eliminated, customers will begin to see credits as a result of the ADIT regulatory liability pass back. The excess ADFIT liability remains in rate base, as per the rate plan, and the ADSIT regulatory asset for recovery will net with the re-established ADSIT liability.

VI. Conclusion

The Company believes by netting the ADFIT regulatory liability against the ADSIT regulatory asset, customers will not see constant changes on their bills for various different surcharges and surcredits.

Respectfully submitted,

NEW YORK AMERICAN WATER COMPANY

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