

BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

**IN THE MATTER OF THE APPLICATION)
OF BLACK HILLS NEBRASKA GAS, LLC,)
D/B/A BLACK HILLS ENERGY, RAPID) APPLICATION NO. NG-109
CITY, SOUTH DAKOTA, SEEKING)
APPROVAL OF A GENERAL RATE)
INCREASE)**

REBUTTAL TESTIMONY AND ATTACHMENTS OF

JUSTIN W. KLAPPERICH

Director of Tax

ON BEHALF OF

BLACK HILLS NEBRASKA GAS, LLC

October 13, 2020

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1 **REBUTTAL TESTIMONY OF JUSTIN W. KLAPPERICH**

2
3 **I. INTRODUCTION AND BACKGROUND**

4 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

5 A. My name is Justin W. Klapperich. My business address is 7001 Mount Rushmore Road,
6 Rapid City, South Dakota 57702.

7 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

8 A. I am employed by Black Hills Service Company, LLC (“BHSC”). I am the Director of
9 Tax. Black Hills Nebraska Gas Utility Company, LLC (“Company” or “BH Nebraska
10 Gas”) is a wholly owned subsidiary of Black Hills Utility Holdings, Inc. (“BHUH”).
11 BHUH is a wholly owned subsidiary of Black Hills Corporation (“BHC”). BHSC is a
12 wholly owned subsidiary of Black Hills Corporation (“BHC”). BH Nebraska Gas conducts
13 business in Nebraska under the trade name of Black Hills Energy.

14 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING?**

15 A. I am testifying on behalf of BH Nebraska Gas. BH Nebraska Gas is the natural gas utility
16 resulting from the recent internal consolidation of the Nebraska gas utility assets and
17 operations of BHC's two former Nebraska gas utility distribution subsidiaries, Black Hills
18 Gas Distribution, LLC (“BH Gas Distribution”) and Black Hills/Nebraska Gas Utility
19 Company, LLC. (“BH Gas Utility”).¹

20 **Q. DID YOU FILE DIRECT TESTIMONY IN THIS PROCEEDING?**

21 A. Yes, my Direct Testimony was filed in this proceeding on June 1, 2020.

¹ See Nebraska Public Service Commission Application No. NG-100.

1 **Q. ARE YOU SPONSORING ANY EXHIBITS TO YOUR REBUTTAL TESTIMONY?**

2 A. No.

3 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

4 A. The purpose of my testimony is to respond to issues raised in Answer Testimonies of
5 Ms. Mullinax as it relates to Accumulated Deferred Income Taxes (“ADIT”), and Excess
6 Deferred Income Taxes (“EDIT”) / Deferred Deficient Income Taxes (“DDIT”).

7 **II. ACCUMULATED DEFERRED INCOME TAXES**

8 **Q. DO YOU AGREE WITH MS. MULLINAX’S PROPOSAL TO DISALLOW NON-**
9 **PLANT ITEMS FROM THE NET ADIT OFFSET IN RATE BASE?**

10 A. No, I do not.

11 **Q. PLEASE EXPLAIN.**

12 A. The disallowance of rate base treatment for non-plant ADIT, in this case a net deferred tax
13 asset (“DTA”), is not consistent with the economics of the transaction and associated cash
14 outlay by the utility. Rate base should, ultimately, be a measure of funds invested in the
15 business by the utility. Non-plant deferred tax *assets* reflect a situation where the deferred
16 tax expense collected from customers is *less than* the amounts paid to the government. In
17 the time between payment to the government and future collection from customers, it is
18 appropriate to allow for a return in rate base on the income tax funds paid. It is the flipside
19 of the widely accepted notion that the deferred tax *liabilities* are deferred tax collections
20 from customers that are *more than* amounts paid to the government. In the time between
21 collection from customers and payment to the government, the utility enjoys cost-free

1 capital² that is appropriate to reflect as a rate base reduction. Specifically, here, the DTAs
2 proposed to be disallowed reflect future deductions not yet taken by the Company for
3 typical ratemaking cost-of-service expense items such as employee benefits, retiree
4 healthcare, pension, bad debt, prepaid software maintenance and insurance expenses, and
5 state income taxes. The deduction for most of these items does not occur until such items
6 are paid in cash (as opposed to accrued for regulatory accounting purposes). If the utility
7 has not realized the cash flow benefit of taking the deduction (since it occurs in the future),
8 a rate base increase is a proper reflection of monies invested by the utility in the rate base.

9 **Q. PLEASE PROVIDE AN EXAMPLE OF THE ECONOMICS AND CASH TAX**
10 **IMPLICATIONS OF NON-PLANT BOOK/TAX DIFFERENCES?**

11 **A.** Borrowing from Mrs. Mullinax’s testimony, bad debt expense is one cost-of-service item
12 that has a book/tax timing difference. Conceptually, it is helpful to view one item such as
13 bad debt in isolation for its impacts on the current/cash and deferred tax expense accrual.
14 The book/tax difference arises because bad debt is typically expensed when sent to the
15 collection agency for regulatory accounting purposes. The Internal Revenue Code,
16 however, does not allow a deduction until the debt is considered wholly worthless, which
17 typically means that the collection agency has exhausted all collection efforts. In the year
18 the accounting expense is recorded but tax deduction is not yet allowed, the utility pays
19 more in cash taxes to the government than the total accrued income tax collected in rates
20 because taxable income exceeds book income. In the future year when the deduction
21 occurs, the utility pays less in cash taxes than the total accrued income tax collected in rates

² Also known as and referred to by Ms. Mullinax at page 22 line 2 of her testimony as an “interest free loan from the government.”

1 because taxable income is less than book income. This is illustrated in the yellow
 2 highlighted boxes of a hypothetical example of a book/tax difference in Table 1 below:

3 **Table 1**

	Pre-TCJA; Last Rate Review			Post-TCJA; Current Rate Review	
Income Statement	Regulatory Books	Tax Return	Revalue @ 12.31.17	Regulatory Books	Tax Return
Gross Margin	1000			1000	
Exp	(800)			(800)	
Bad Debt Exp	(10)			0	
Operating Income	190			200	
Interest Exp	(90)			(100)	
Pre-Tax Book Income	100	100		100	100
Book/Tax Differences					
Bad Debt Exp		10			(10)
Taxable Income on Tax Return		110			90
Federal Tax Rate		35%			21%
Current (Cash) Tax (To)/From Gov't	(38.5)	38.5		(18.9)	18.9
Deferred Tax (Exp)/Benefit	3.5			(2.1)	
Total Tax Exp_Collected in Rates	(35.0)			(21.0)	
Net Income	65.0			79.0	
Balance Sheet					
	Balance				Balance
Deferred Tax Asset_Bad Debt	3.5		(1.4)	(2.1)	0.0
Regulatory Asset_Deficient Deferred Tax			1.8		1.8
Deferred Tax Liab-Tax on Tax Gross Up			(0.4)		(0.4)

4
 5 **Q. HOW DO YOU REBUT MS. MULLINAX’S LOGIC THAT THERE SHOULD BE**
 6 **A DIRECT RELATIONSHIP BETWEEN RATE BASE COMPONENTS AND**
 7 **ONLY ADIT ASSOCIATED WITH BALANCE SHEET ITEMS IN RATE BASE**
 8 **SHOULD BE INCLUDED?**

9 **A.** There is logical appeal to Ms. Mullinax’s position that there should be a matching between
 10 ADIT items and its asset/liability counterpart in rate base. The better match, however, when
 11 it comes to income tax expense, is that there must be a match between the ADIT item and
 12 its counterpart in cost-of-service utility operating income/expense. It is, of course, pre-tax
 13 operating income and expense that drives the income tax allowance included in utility
 14 ratemaking, not rate base.

1 **Q. HAS THE COMPANY ESTABLISHED A MATCH BETWEEN THE ADIT ITEMS**
2 **AND ITS COUNTERPART IN COST-OF-SERVICE?**

3 **A.** Yes. In discovery the Company produced in response to Data Request No. PA-268 a tracing
4 of each non-plant ADIT item to its counterpart in cost-of-service. Ms. Mullinax does not
5 dispute that the expense items are reflected in the determination of operating income in the
6 cost of service formula, but argues “they are not included as a direct component of rate
7 base on which a return is calculated, which is the basis for Mrs. Mullinax’s concern.”³

8 **Q. IS THERE ANY NEBRASKA PSC REGULATION, RULEMAKING, OR ORDER**
9 **STATING THAT NON-PLANT ADIT SHOULD NOT BE INCLUDED IN RATE**
10 **BASE?**

11 **A.** To my knowledge, there has been no rulemaking or order by the Nebraska PSC establishing
12 that it is inappropriate to include non-plant DTAs. The Public Advocate is, similarly, “not
13 aware of any Nebraska PSC rules, decisions, or prior testimony” on this issue as was
14 admitted in discovery.⁴ As Ms. Mullinax points out, however, in the Company’s and its
15 predecessors prior rate review filings only plant related ADIT was included as an offset in
16 the rate base model. In my view, this was historically a simplifying practice that should be
17 improved to reflect the true economics and cash tax consequences of the underlying
18 transactions.

19 **Q. HOW HAVE OTHER JURISDICTIONAL COMMISSIONS RULED ON THIS**
20 **MATTER?**

³ See Response to Data Request No. BH-PA 1-7c.

⁴ See Response to Data Request No. BH-PA 1-8.

1 A. In *Kern River Gas Transmission Company*, FERC Docket No. RP04-274-000 the FERC
2 addressed ADIT assets. It concluded:

3 229. There is a second type of timing difference that can have the
4 opposite effect. It is possible that some accounting entries will decrease
5 expenses or increase income for IRS purposes faster than would be the
6 case for accounting purposes. In this case the cash flow from the tax
7 allowance embedded in the regulated entity's rates is less than the
8 income tax payments that are generated by the higher income. When the
9 regulated entity pays for an expense earlier than would be under the
10 Commission's regulatory accounting system, it is committing more
11 funds to the business. The difference is therefore capitalized and added
12 to the rate base. The difference in the timing that results is capitalized
13 and added to the rate base to allow a somewhat higher return on the
14 additional funds that have been committed to the enterprise. As the
15 accounting entries for these expenses are entered (usually allowance of
16 funds used during construction), the difference in timing is reversed, the
17 short-term addition to the rate base decreases, and return drops. This
18 timing difference is reflected as an ADIT debit, or regulatory asset, in
19 Account No. 190.⁵

20 Although this FERC decision is not binding on other Commissions, it does provide an
21 excellent analysis of the issue.

⁵ 117 FERC ¶61,077 (2006).

1 **Q. IS THE COMMISSION FREE TO CHANGE ITS HISTORICAL PRACTICE TO**
2 **INCLUDE ONLY PLANT-RELATED ADIT IN RATE BASE?**

3 A. Yes, as here, where there is an opportunity to improve the ratemaking process and reflect
4 the true economics of transactions, the Commission should distinguish and overrule past
5 practice. In my opinion, this is particularly true when there is seemingly no discussion in
6 prior orders relative to the rationale concerning the issue.

7 **Q. WHY DID THE COMPANY NOT MAKE A PROACTIVE DISCLOSURE OF THE**
8 **CHANGE IN FILING POSITION AS MS. MULLINAX SUGGESTED SHOULD**
9 **HAVE BEEN DONE?**

10 A. In hindsight, I agree that a proactive disclosure should have been made before the
11 Commission in my direct testimony given the magnitude of the amounts and disparity from
12 past practice. It was an oversight in that I failed to recognize this ratemaking practice
13 unique to Nebraska in prior rate filings. Other state jurisdictions which I support routinely
14 include both plant and non-plant ADIT in rate base and provide recovery of non-plant
15 DDIT. I incorrectly assumed Nebraska followed a similar historical practice. That said, I
16 strongly believe the better ratemaking practice is to include non-plant ADIT due to the
17 economics between utility and customer for the reasons discussed in my testimony above.

III. DEFICIENT/EXCESS DEFERRED INCOME TAX REGULATORY ASSETS/LIABILITIES

Q. DO YOU AGREE WITH MS. MULLINAX’S PROPOSAL TO DISALLOW NON-PLANT ITEMS FROM COLLECTION AS REGULATORY ASSETS FOR DEFICIENT DEFERRED INCOME TAXES RELATED TO THE TAX CUTS AND JOBS ACT (“TCJA”)?

A. No, I do not.

Q. PLEASE EXPLAIN.

A. Ms. Mullinax relies on prior ratemaking practice regarding exclusion of the pre-TCJA non-plant ADIT from rate base as the rationale for disallowing non-plant DDIT in the amount of \$2.2 million. In short, the PA’s argument is that TCJA revaluation did not qualify for regulatory accounting treatment because the underlying ADIT was not in rate base in prior rate filings. In the same vein as the arguments regarding non-plant ADIT, her logic is flawed in that it looks to a matching between the DDIT item and the treatment in prior rate filings’ rate base. The better match is to marry the DDIT item and the treatment in prior rate filings’ cost-of-service. The very notion of “excess” and “deficient” deferred tax regulatory liabilities and assets, respectively, is that the utility over or under collected tax expense in cost-of-service ratemaking. Rate base treatment is not determinative of over/under collections of the income tax allowance, rather, utility pre-tax operating income is determinative. Here, the \$2.2 million of Non-Protected Non-Property DDIT sought to be recovered by the Company represents a regulatory asset since the tax benefit of the deduction of the cost-of-service expense items in the prior rate filing was reflected in rates at the previous 35% tax rate, yet the future deduction, post-TCJA, is only 21%. When a utility reduced customer rates by 35% of the cost-of-service expense item and the tax rate

1 changes such that the utility only enjoys a 21% tax shield of the expense item when the
2 deduction is available to be claimed, it is deficient in its income tax allowance collection
3 and should be made whole via the regulatory process. Put more simply, each \$1 dollar of
4 the expense items at issue embedded in utility rates (set pre-TCJA) at an after-tax amount
5 of \$0.65 cents, however, the after-tax cost to the Company post-TCJA is \$0.79 cents. The
6 \$0.14 cent difference is proper to reflect as a regulatory asset within the EDIT/DDIT net
7 balances as the Company has proposed and should not be disallowed as Ms. Mullinax
8 suggests.

9 **Q. IS THERE A MATCH BETWEEN THE NON-PLANT DDIT ITEMS AND THEIR**
10 **COUNTERPARTS IN COST-OF-SERVICE IN PRIOR RATE FILINGS?**

11 **A.** Yes. Again, the underlying expense items for employee benefits, retiree healthcare,
12 pension, bad debt, prepaid software maintenance and insurance expenses and state income
13 taxes are typical costs of doing business and appear to be allowed for recovery in the prior
14 rate review cost-of-service models. Ms. Mullinax did not review prior rate review models
15 but admitted she “would not find it unusual that these expense items...were previously
16 included in costs of service.”⁶

17 **Q. DO YOU AGREE WITH THE MODIFICATION MS. MULLINAX SUGGESTS ON**
18 **PAGE 27 LINES 3-14 REGARDING THE CALCULATION OF THE TAX GROSS**
19 **UP OF PROTECTED PROPERTY EDIT BALANCE?**

20 **A.** No, on its face, Exhibit No. DHM-4 Schedule 3 lines 4-7 rate base adjustment is overstated.
21 Ms. Mullinax proposed to reclass a \$3.7 million item and ultimately translates it into a
22 \$13.2 million rate base impact. The overstatement is due to a misunderstanding as to the

⁶ See Response to Data Request No. BH-PA 1-7a.

1 Protected Property EDIT Account. On line 6, the Public Advocate incorrectly applied a tax
2 gross-up to the regulatory liability balance for Protected Property EDIT that was already
3 presented grossed-up for taxes.⁷ In fact, instead of applying a tax-on-tax gross up to make
4 the liability bigger, the Public Advocate should have reflected an offsetting deferred tax
5 asset⁸ at the combined tax rate of 27.17% to net down the liability smaller.

6 **Q. MS. MULLINAX DISAGREES WITH THE COMPANY’S PROPOSAL TO USE**
7 **THE NOL DDIT REGULATORY ASSET TO SATISFY THE ARAM**
8 **AMORTIZATION OWED TO CUSTOMERS OVER THE NEXT FOUR YEARS.**
9 **DO YOU AGREE?**

10 A. No. While there are multiple ways for the Commission to dispose of non-protected
11 regulatory assets and liabilities, the Company’s proposal represented a fair outcome to
12 customers since amortizations of regulatory liabilities for EDIT and amortizations of
13 regulatory assets for DTA NOL DDIT were equal and offsetting such that there was no
14 impact to rates or rate base. If the Public Advocate’s position were to be accepted, however,
15 Ms. Mullinax in her workpapers fails to reflect a necessary pro forma adjustment to rate
16 base for the annual ARAM refund to customers to be reflected in base rates under her
17 proposal. A pro forma adjustment for \$736,833 gross before-tax or \$536,635 net after-tax
18 is appropriate as the return of excess deferred tax to customers relieves a liability included
19 as an offset to rate base and effectively increases rate base. If tax expense is reduced for

⁷ See “PWC Whitepaper Understanding the Potential Impact of Tax Reform on 2018 Net Revenues” which states “the regulatory liability...reverse on the balance sheet at the gross-up values.”

⁸ See Bender, Accounting for Income Taxes Sec. 17.02[9] which states “tax-related regulatory asset and *regulatory liability* are temporary differences requiring deferred tax liabilities and *deferred tax assets*, respectively. *Emphasis added.*”

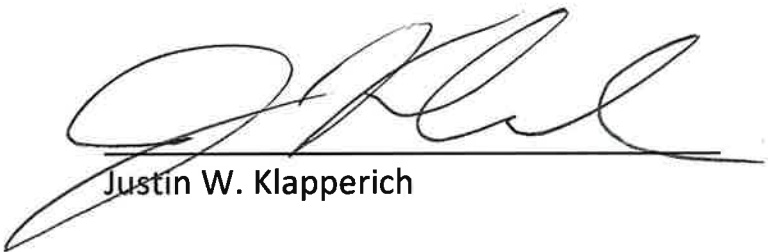
1 ARAM, it is fair to make a corresponding adjustment to reflect the pro forma satisfaction
2 of the liability in rate base.

3 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

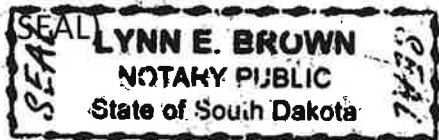
4 A. Yes.

STATE OF NEBRASKA)
) SS
COUNTY OF LANCASTER)

I, Justin W. Kapperich, being first duly sworn on oath, depose and state that I am the witness identified in the foregoing prepared testimony and I am familiar with its contents, and that the facts set forth are true to the best of my knowledge, information and belief.


Justin W. Kapperich

Subscribed and sworn to before me this 9TH day of October, 2020.





Notary Public

My Commission Expires: 6-29-2024