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APPLICATION OF CENTERPOINT ENERGY HOUSTON ELECTRIC, LLC, RELIANT ENERGY RETAIL SERVICES, LLC AND TEXAS GENCO, LP TO DETERMINE STRANDED COSTS AND OTHER TRUE-UP BALANCES PURSUANT TO PURA § 39.262	§ § § § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

REBUTTAL TESTIMONY OF

ROBERT W. HRISZKO

FOR

CENTERPOINT ENERGY HOUSTON ELECTRIC, LLC, RELIANT ENERGY RETAIL SERVICES, LLC AND TEXAS GENCO, LP

June 14, 2004

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I. INTRODUCTION

Q. Would you please state your name, occupation and business address?

A. My name is Robert W. Hriszko. I am a senior director in the firm of PricewaterhouseCoopers LLP. My business address is 1 North Wacker, Chicago, Illinois 60606.

Q. Have you previously submitted direct testimony in this proceeding?

A. Yes.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my testimony is to rebut various income tax adjustments proposed in the testimony of Mr. Lane Kollen, witness for the Houston Council for Health and Education, Mr. David J. Effron, witness for the Office of Public Utility Counsel, Ms. Ellen Blumenthal, witness for the City of Houston and the Coalition of Cities and Mr. Darryl Tietjen, witness for the Public Utility Commission of Texas.

III. SUMMARY OF OPINION

Q. What is your opinion regarding the accumulated deferred income tax (ADIT) offset adjustment proposed by Ms. Blumenthal and Mr. Effron?

A. In my opinion, it is inappropriate to offset ADIT against stranded costs. ADIT is not a regulatory liability, nor does it constitute ratepayer supplied funds. In addition, an offset of ADIT against stranded costs would, in effect, act as a further disallowance of otherwise recoverable stranded costs.

Q. What is your opinion of Mr. Tietjen's proposal to gross up the ADIT related to any disallowance of stranded costs?

A. I believe that this proposal would result in a violation of the normalization provisions of the Internal Revenue Code.

Q. What is your opinion regarding investment tax credit (ITC) and excess deferred income tax (EDIT) offsets proposed by Ms. Blumenthal, Mr. Effron, Mr. Kollen and Mr. Tietjen?

A. I believe that offsetting these amounts against either stranded cost or regulatory assets would result in a violation of the normalization provisions of the Internal Revenue Code.

Q. What is your opinion of the adjustments proposed by Mr. Kollen and Ms. Blumenthal to reduce the income tax related regulatory assets to zero by offsetting such assets by ADIT, ITC and EDIT?

A. I believe that offsetting the regulatory assets by ADIT is inappropriate because ADIT is not a regulatory liability. I believe that offsetting regulatory assets with regulatory liabilities relating to ITC and EDIT would result in a violation of the normalization provisions of the Internal Revenue Code.

IV. THE ADIT OFFSET TO STRANDED COSTS PROPOSED BY MS. BLUMENTHAL AND MR. EFFRON.

Q. What is your understanding of the adjustments proposed by Ms. Blumenthal and Mr. Effron to reduce the recovery of stranded costs by some portion or all of ADIT?

A. Ms. Blumenthal proposes to reduce stranded costs by $1,101,480,037 of ADIT on a dollar for dollar basis. Mr. Effron proposes to reduce stranded costs by $1,242,642,000 of ADIT in two pieces, one for $616,034,000 representing an amount he computes as the present value of ADIT return and the second for $626,608,000 representing an amount he computes as the present value of ADIT principal. Both Ms. Blumenthal and Mr. Effron rely on a fundamental premise that ADIT represents funds "collected from ratepayers", "ratepayer supplied funds" and/or a regulatory liability that is owed to ratepayers.

Q. Do you agree with these adjustments?

A. No. Both Ms. Blumenthal and Mr. Effron have relied on a faulty premise regarding the nature of deferred taxes. As Mr. Tietjen has noted, the Commission has consistently rejected this approach. Thus, their adjustments are without merit.

Q. Mr. Hriszko, please explain how deferred taxes arise.

A. Deferred taxes arise from differences between the book basis and tax basis of an asset. Such differences primarily arise when a taxpayer uses accelerated depreciation deductions for tax purposes and straight line depreciation deductions for book purposes or when the useful life of an asset is different for book and tax purposes.

A numerical example is perhaps the best way to understand ADIT: assume a utility has owned a plant for several years. Currently, the plant has a net book basis of $1,000 and a net tax basis of $500. For tax purposes, the utility has been claiming accelerated depreciation deductions on the plant. Accelerated depreciation allows the utility to claim larger depreciation tax deductions (which reduce tax basis) in the early years of the useful life of the plant and smaller depreciation deductions (or even no depreciation deductions) in the later years of the useful life. The accelerated tax depreciation in the early years exceeds the amount of depreciation deductions the utility would have been able to deduct had it simply claimed equal or "straight line" tax depreciation deductions over the life of the plant. For book purposes, straight line depreciation is the governing depreciation methodology to determine net book basis. Because of the differences between straight line and accelerated depreciation, the utility's net book basis in the plant will be higher than its net tax basis in the plant in the early years of the plant's useful life.

If the utility sells the plant for its net book value of $1,000, the utility would recognize $500 of tax gain and thereby owe federal tax of $175 (35% of $500). Thus, $175 is the required deferred tax with respect to the plant. This amount reflects the future liability to the federal government that the utility will incur when the plant's book value is realized. The realization of the plant's value may be triggered either all at once by a sale, as illustrated by this example, or over the remaining useful life of the plant as future depreciation deductions are taken. In either case, the deferred tax liability is a liability the utility owes to the federal government. A utility's total ADIT equals the sum of the federal tax payable in the future on the difference between its net book basis and net tax basis on each of its assets.

ADIT may also arise from a difference in the useful life of an asset for book and tax purposes. A numerical example is helpful in understanding this issue. Assume a utility acquires a plant for $1,000. Assume for book purposes the plant is recovered over a 10-year life on a straight line basis. Consequently, $100 of book depreciation is taken in each year of the plant's book life. However, for tax purposes, assume the plant is depreciated over a 5-year useful life. For the sake of simplicity, assume that tax depreciation deductions are also calculated on the straight line basis so that $200 of tax depreciation is taken in each of the first 5 years. The table below sets forth the annual book and tax depreciation amounts on the hypothetical plant and demonstrates the accrual of, and reversal of, ADIT with respect to the plant.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total Year 1-5
Book Depreciation	100	100	100	100	100	500
Tax Depreciation	(200)	(200)	(200)	(200)	(200)	(1000)
Difference in Book/Tax Depreciation	(100)	(100)	(100)	(100)	(100)	(500)
Increase in ADIT	35	35	35	35	35	175

	Year 6	Year 7	Year 8	Year 9	Year 10	Total Year 6-10
Book Depreciation	100	100	100	100	100	500
Tax Depreciation	0	0	0	0	0	0
Difference in Book/Tax Depreciation	100	100	100	100	100	500
Decrease in ADIT	(35)	(35)	(35)	(35)	(35)	(175)

As the table demonstrates, the ADIT accrued in the earlier years of the plant's book life is reversed in the later years of the plant's book life.

Q. Do deferred taxes represent a regulatory liability?

A. No, absolutely not. A regulatory liability is a result of rate regulation. Deferred taxes are not a result of rate regulation, but arise under the accelerated depreciation provisions of the Internal Revenue Code. Statement of Financial Accounting Standards 109 provides that:

> [t]he general standards of accounting for the effects of regulation set forth in Statement 71 require recognition of a deferred tax liability or asset for the tax consequences of temporary differences because a regulator cannot relieve a regulated enterprise of a liability or asset that was not created by rate actions of the regulator.[1]

Because deferred taxes are created under the Internal Revenue Code and not by regulator action, ADIT is not a regulatory liability.

Q. Do deferred taxes represent a loan from ratepayers, ratepayer supplied funds or funds collected from customers?

A. No, absolutely not. Deferred taxes are a loan from the federal government to the utility, not from the ratepayers to the utility. Deputy Assistant Secretary of the Treasury for Tax Analysis Emil M. Sunley's testimony before the Oversight Committee of The Committee on Ways and Means on March 28, 1979 addresses this point directly:

> Thus, to the extent that taxable income of utilities is measured with the use of depreciation imputation rules that depart from those used by regulatory commissions, the Federal government is implementing an interest-free lending program of the type just described. Prior to the modifications of the tax laws beginning in 1954, there was reasonably close correspondence between the regulatory and tax rules governing depreciation imputation. In regulated industries, therefore, the post-1954 deviations of tax rules for income measurement from regulatory norms marked the introduction of a subsidy program that may only be correctly accounted for as a source of interest-free loans. (See Figure RWH-R2)

[1] Accounting for Income Taxes, Statement of Financial Accounting Standards No. 109 (Financial Accounting Standards Bd. 1992). See Figure RWH-R1.

The testimony of Deputy Assistant Secretary of the Treasury for Tax Legislation Daniel I. Halperin before The Committee on Ways and Means on April 15, 1980 is to the same effect:

> Accelerated depreciation is no different than an interest-free loan from the Government and it should be treated as any other loan would be with the one exception that this loan is provided at a zero interest rate so it is not necessary to recover interest costs on this loan. (See Figure RWH-R3)

The testimony of the Director, Office of Tax Analysis, Department of Treasury, John G. Wilkins before the Subcommittee on Energy Conservation and Power of the House Committee on Energy and Commerce on June 12, 1984, is also to the same effect:

> When tax depreciation rules permit deductions at a faster rate than the actual physical deterioration of capital assets, the economic effect is the deferral of tax liability. The result is the same as if the Treasury were to extend a series of interest-free loans to the taxpayer during the early years of the asset's life, which are repayable in the later years. (See Figure RWH-R4)

In FERC Order No. 144, the FERC further addressed the same issue:

> To illustrate certain aspects of the difference between tax normalization and flow-through in revenue requirements over time, the Notice and the attached Staff Study used an analogy of a customer loan. It is apparent from the comments, however, that this "analogy" increased rather than reduced confusion. Indeed, the source of many of the criticisms of tax normalization can be traced to the *erroneous*

premise that a loan is being made by ratepayers to the utilities. To the extent that the Notice conveyed or supported this notion as fact rather than as an illustrative analogy, the Commission now finds it in error. (emphasis added)[2]

As a final dismissal of the argument, the Federal Energy Regulatory Commission went on to state in Order No. 144 that "[s]ince the Commission finds the analysis of tax normalization from the perspective of a customer loan to have little merit, it also finds little merit in the criticisms of the tax normalization policy that are based on the presumption of a customer loan."[3]

The federal authorities set forth above clearly conclude that ADIT does not represent a loan from ratepayers, but a loan from the U.S. government. Accordingly, the factual underpinning of the Intervenors' argument is incorrect.

Further, ADIT cannot be a loan from ratepayers to the utility because, as all parties must admit, there is a third party to the transaction—the U.S. government. The federal tax liability is paid to the IRS, not the utility or the ratepayers.

This Commission has rejected the claim that ADIT constitutes a loan from ratepayers that should offset a utility's recovery. The Commission held in a joint order for Docket Nos. 6765 and 6766 that "Because ratepayers are currently providing FIT on a normalized basis in the Company's cost of service, this [ADIT] adjustment is reasonable and necessary to recognize ***government supplied*** capital"[4] (emphasis added). Indeed, the Commission Staff's own expert recognizes that ADIT does not offset or reduce a utility's recovery of its stranded costs.[5]

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[2] FERC Order 144, 46 Fed. Reg. 26,613 (May 14, 1981). See Figure RWH-R5.
[3] FERC Order 144, 46 Fed. Reg 26,613 at 26,625. See Figure RWH-R5.
[4] *See* the Joint Order in Docket No. 6765 *Petition of Houston Lighting and Power Company for Authority to Change Rates*, and Docket No. 6766, *Petition of Houston Lighting and Power Company for Approval of Proposed Interim Accounting Treatment for Limestone Unit 1*, Finding of Fact #58. See Figure RWH-R21.
[5] See Direct Testimony of Darryl Tietjen at p. 13.

Q. If ADIT is not offset against stranded costs, is there an unintended benefit that would accrue to the Company?

A. No. A numerical example is helpful to avoid any confusion over whether the utility obtains a benefit from ADIT following deregulation. The chart from page 5 is reproduced below:

	Year 1	Year 2	Year 3	Year 4	Year 5	Total Year 1-5
Book Depreciation	100	100	100	100	100	500
Tax Depreciation	(200)	(200)	(200)	(200)	(200)	(1000)
Difference in Book/Tax Depreciation	(100)	(100)	(100)	(100)	(100)	(500)
Increase in ADIT	35	35	35	35	35	175

	Year 6	Year 7	Year 8	Year 9	Year 10	Total Year 6-10
Book Depreciation	100	100	100	100	100	500
Tax Depreciation	0	0	0	0	0	0
Difference in Book/Tax Depreciation	100	100	100	100	100	500
Decrease in ADIT	(35)	(35)	(35)	(35)	(35)	(175)

If the utility's generation assets are deregulated at the end of year 5, the utility will still not be entitled to any tax depreciation in years 6-10. Yet the utility will continue to earn income from the recovery of stranded cost recovery charges. Because no tax depreciation exists to offset this income, the utility will incur *increased* tax liability on its increased income. As book earnings exceeded tax earnings in years 1-5, tax earnings will exceed book earnings in years 6-10. The payment of the "extra" tax in years 6-10 will reduce the accumulated deferred tax liability to zero.

Q. Would the Company suffer detrimental economic consequences if ADIT were offset against stranded costs?

A. Yes. The utility would in fact suffer detrimental effects if ADIT were allowed to offset stranded costs. If ADIT offset stranded cost recovery, the utility would not ultimately recover the full amount of stranded cost allowed by the Commission. Supplementing the prior numerical example best illustrates this point.

With the previous example, assume that the true-up proceeding occurs at the end of year 5 and that the utility is seeking stranded cost recovery of $1,000, but that the Intervenors are seeking to reduce such recovery by the accumulated deferred tax of $175, that accrued during years 1-5. Assume that the Commission allows the full recovery of $1,000 which the utility would recover pro rata over 20 years, or $50 per year. Assume further that in years 1-5, the utility has $300 of revenue in each year from the sale of electricity with rates being set by the Commission. In years 6-10, because of deregulation, assume that the utility's income from the sales of electricity decreased to $250 per year because the rates in a deregulated environment are lower. The table set forth below incorporates these additional facts.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total Year 1-5
Book Depreciation	100	100	100	100	100	500
Tax Depreciation	(200)	(200)	(200)	(200)	(200)	(1,000)
Difference in Book/Tax Depreciation	(100)	(100)	(100)	(100)	(100)	(500)
Increase in ADIT	35	35	35	35	35	175
Taxable Income-Revenue from Electricity Sales	300	300	300	300	300	1,500
Net Taxable Income	100	100	100	100	100	500

	Year 6	Year 7	Year 8	Year 9	Year 10	Total Year 6-10
Book Depreciation	100	100	100	100	100	500
Tax Depreciation	0	0	0	0	0	0
Difference in Book/Tax Depreciation	100	100	100	100	100	500
Decrease in ADIT	(35)	(35)	(35)	(35)	(35)	(175)
Taxable Income-Revenue from Electricity Sales	250	250	250	250	250	1,250
Taxable Income-Stranded Cost	50	50	50	50	50	250
Net Taxable Income	300	300	300	300	300	1,500

As the table reflects, the utility receives no depreciation offset to its taxable income in years 6-10, as it did in years 1-5, because at the end of year 5, the utility has reduced its tax basis in the asset to zero. Thus, there is no additional tax depreciation the utility may claim. Accordingly, the utility's taxable income is greater in years 6-10 because it no longer enjoys the depreciation deduction to its taxable income. Further, the recovery of stranded cost also constitutes taxable income to the utility.

If the Commission were to reduce the utility's recovery of stranded cost by the amount of ADIT, then the utility would essentially be treated as paying the ADIT twice. One payment occurs in the form of higher taxable income in years 6-10 because of the absence of tax depreciation deductions in years 6-10. The second payment occurs by the reduced amount of stranded cost recovery in years 6-10. Because the utility would in essence incur a double payment of ADIT, the utility could not recover the full amount of stranded costs awarded by the Commission.

Q. What is your conclusion regarding the adjustments proposed by Ms. Blumenthal and Mr. Effron to reduce stranded costs by ADIT?

A. Both adjustments rely on the faulty premise that ADIT represents funds collected from ratepayers and should be rejected by the PUC. This conclusion is buttressed by the fact that if ADIT reduces the recovery of stranded costs the net result would be a disallowance of stranded costs the PUC otherwise would intend to be recovered by the company as my numerical example in my previous response demonstrated.

Q. Are there further observations you have related to the testimony of intervenors and staff testimony related to the offset of ADIT?

A. Yes. The following questions and answers relate to the specific observations I have on the direct testimony Mr. Effron and Ms. Blumenthal related to the offset of ADIT.

Q. On page 14 of Mr. Effron's direct testimony, he states "Indeed, there is no reason to distinguish between the EDIT and the non-excess ADIT for ratemaking purposes for as long as the assets giving rise to the deferred taxes remain public utility property." Do you agree with his statement?

A. No. There are many reasons to distinguish ADIT from EDIT. First, EDIT is recorded in an entirely different account, as a regulatory liability. ADIT is not a regulatory liability. Second, the Tax Reform Act of 1986 sets forth specific rules for amortization of EDIT which do not affect ADIT. Lastly, upon deregulation, ADIT still exists whereas EDIT does not.

Q. Page 25 of Mr. Effron's direct testimony, he asserts that the Company has not recognized the existence of the ADIT on the generating plant in any way. Do you agree with this assertion?

A. No. The Company believes that the securitization proceeding, which follows the true-up proceeding, is the appropriate venue for consideration of the ADIT. The Company response to TIEC5-68 clearly states this, as follows: "The amounts shown on Schedule IX would not affect the determination of stranded costs. The accumulated deferred income tax amounts could affect the recovery of stranded costs if the PUCT uses a time value of money concept similar to the concept used in the first securitization. In the first securitization, the Company used the time value concept only for accumulated deferred income taxes and not for any of the other amounts on Schedule IX. This is consistent with the PUCT Staff's conclusion in Project No. 26892 with respect to accumulated deferred income taxes included on Schedule IX. The PUCT Staff stated: Consideration of tax effects has a bearing on the present-value calculations of revenue requirements.

Therefore, even if it is the case that consideration of a company's tax information does not have a direct effect on the quantification of stranded costs, such information will need to be considered when the method of recovery of stranded costs is determined." (See Response to TIEC 5-68, attached hereto at Figure RWH-R6)

Q. Do you have any additional observations about Mr. Effron's ADIT related adjustments?

A. Yes. The two adjustments proposed by Mr. Effron ($626,608,000 and $616,034,000) equal $1,242,642,000. This amount equals the total ADIT that Mr. Effron considers related to depreciable generation assets from Schedule IX. He shows this amount on Exhibit DJE-2. Thus, even though Mr. Effron begrudgingly admits on page 28 of his direct testimony that ADIT will be paid to the government and is a "real liability", he has, in effect, reduced the recovery of stranded costs by the total ADIT amount.

Q. On pages 29 and 30 of his direct testimony, Mr. Effron believes that Texas Genco's ADIT liability should be funded by CenterPoint Energy Houston Electric LLC ("CEHE") when ADIT reverses. He suggests that "The Tax Allocation Agreement should have been structured so that TGN was not responsible for the current federal income tax liability resulting from the net excess of book over tax depreciation on generating assets in service as of December 31, 2001." Do you agree with this recommendation?

A. No. Mr. Effron in his deposition stated that he had never seen a tax allocation agreement that operated in this manner.[6] In point of fact, I have never seen nor been made aware of, a provision of a tax allocation agreement that operates in this manner either. Further, a rational tax allocation agreement would <u>not</u> contain

[6] Deposition of David J. Effron at 136. See Figure RWH-R25.

such a provision because ADIT is needed at CEHE to pay the income taxes on the future collection of stranded costs.

Q. On page 31 of his testimony Mr. Effron states that "The quantification of the recoverable stranded costs should be adjusted to eliminate the value of the ADIT liability improperly assigned to TGN." Do you agree with Mr. Effron's assertion that ADIT was improperly assigned to TGN?

A. Absolutely not. ADIT was assigned to TGN based on the requirements of generally accepted accounting principles. All ADIT that was assigned to TGN related solely to the generation assets which were also transferred to TGN. The generation assets transferred to TGN had a book/tax basis difference attributable to the excess of tax depreciation over book depreciation. Under SFAS No. 109, this is a temporary difference requiring ADIT to be recorded at TGN.

Q. On page 13 of her direct testimony, Ms. Blumenthal relies upon the definition of "regulatory assets" under PUC Substantive Rules related to securitization to justify her position that ADIT should offset stranded cost recovery. Does the definition of regulatory asset have any relevance to recovery of stranded costs?

A. No. Ms. Blumenthal has confused two distinct concepts. In order to receive recovery for an amount as a stranded cost, it is not relevant whether such amount constitutes a regulatory asset. Conversely, in order to receive recovery for an amount as a regulatory asset, it is not relevant whether such amount constitutes a stranded cost. The definition of stranded cost in PURA makes no reference to regulatory assets, and the definition of regulatory assets in the PUC Substantive Rules makes no reference to stranded costs. Compare PURA § 39.251(7) with PUC Subst. R. 25.263(c)(7). Therefore, the definition of regulatory asset has no relevance to determining the Company's recovery of its stranded costs.

Q. On page 18 of her direct testimony, Ms. Blumenthal states that ADIT was included in the ECOM model, thus inferring that it should be considered in this docket. How was ADIT reflected in the ECOM model?

A. ADIT was included in the ECOM model in the calculation of ratebase. In that context, it reduced the return amount allowed. ADIT was not offset against estimated stranded costs. Thus, the inclusion of ADIT in the preliminary ECOM model is not a basis for offsetting ADIT against stranded costs in this proceeding.

Further, stranded costs are determined through a market mechanism, not the ECOM model, except in connection with the valuation of nuclear assets that cannot otherwise be valued. Consequently, the contention that the ECOM Model's method supports an offset of ADIT against stranded cost recovery must be rejected.

Q. In his direct testimony, does Mr. Tietjen propose an offset to the Company's recovery of stranded cost for ADIT?

A. No. In fact, he specifically rejects such an offset.

V. PROPOSAL OF MR. TIETJEN TO GROSS UP DISALLOWED STRANDED COSTS

Q. Do you agree with Mr. Tietjen's proposal to "gross up" disallowed stranded costs?

A. No. The effect of Mr. Tietjen's proposal is to give tax benefits to the ratepayers on a portion of generation plant that will not be paid for by the ratepayers. Aside from the fundamental inequity of the proposal, it would violate the tax normalization rules.

Q. Please explain the application of the normalization rules.

A. When the recovery of plant related costs is disallowed in a ratemaking proceeding, these so-called "below the line" costs are borne by the shareholders. If the tax benefits attributable to the disallowed plant costs are given to the ratepayers, there is a fundamental inconsistency that results. This inconsistency was recognized by the IRS in a series of private letter rulings, several of which emanated from rate proceedings in the State of Texas. See PLR 9547008, PLR 9312007 and PLR 9613004. (See Figures RWH-R7, RWH-R8 and RWH-R9, respectively.) These private letter rulings held that there would be a normalization violation if any tax benefits subject to the normalization rules, namely ITC and/or accelerated deprecation attributable to disallowed plant costs, are given to the ratepayers. Mr. Tietjen's proposal falls squarely within the holdings of these private letter rulings.

Q. Are there any other authorities that bear upon Mr. Tietjen's proposal?

A. Yes. The Texas Supreme Court decision in PUC v. GTE- Southwest, Inc., 901 S.W. 2d 401 (Tex. 1995) (See Figure RWH-R10) held that the tax benefits related to disallowed costs should not be given to the ratepayer. This holding was confirmed in the later case of Gulf States v. PUC, 947 S.W. 2d 887 (Tex. 1997). (See Figure RWH-R11.)

Q. What is your conclusion regarding Mr. Tietjen's proposal?

A. The proposal should be rejected because it would constitute a violation of the tax normalization rules and because it is contrary to Texas law and precedents.

VI. INTERVENOR AND STAFF PROPOSED ADJUSTMENTS TO REDUCE STRANDED COSTS BY INVESTMENT TAX CREDIT AND EXCESS DEFERRED INCOME TAXES

Q. Do you agree that the claimed stranded costs in this docket should be reduced by any ITC or EDIT?

A. No. Ms. Blumenthal, Mr. Effron, Mr. Kollen and Mr. Tietjen all present various adjustments to reduce stranded costs for ITC and/or EDIT. All of these proposed adjustments should be rejected because they would all violate the normalization provisions of the Internal Revenue Code.

To support my conclusion, I will first address ITC and second EDIT.

ITC

Q. What is ITC?

A. ITC refers to investment tax credit. The Internal Revenue Code previously provided a tax credit to taxpayers who made qualifying investments in certain types of equipment and machinery. Congress intended the ITC to stimulate business growth by encouraging businesses to invest capital in qualifying investments. Congress initially enacted the ITC provision (former Internal Revenue Code (the "Code") section 46) in 1962, provided normalization rules applicable to regulated utilities in 1971, and repealed it altogether in 1986.

In contrast to a deduction which offsets taxable income, an ITC is a tax *credit* that offsets a taxpayer's federal *tax liability*. In general, the amount of the ITC was determined by the product of (i) the taxpayer's tax basis in the asset (usually its cost to acquire the asset), (ii) a percentage based on the type of asset (determined based on the asset's useful life in accordance with the terms of former Code section 46 and the regulations issued thereunder), and (iii) the ITC rate (10%). Thus, for long-lived public utility property with a cost of $1,000, an ITC at a 10% rate would generate a credit of $100.

Q. Does ITC have continuing relevance to rate regulated utilities?

A. Yes. Despite its repeal in 1986 and despite the fact that taxpayers have long since realized all of the tax benefits made possible by ITC, ITC continues to have relevance for regulated utilities in terms of how the benefits of ITCs are shared with ratepayers. Specifically, even though the utility realized the ITC tax benefit long ago, the utility must share the ITC benefit with ratepayers over the life of the asset (as described below). Thus, to the extent a regulated utility still owns assets that generated ITC, ITC continues to be shared with ratepayers.

Congress intended that ITC should encourage companies to invest in capital intensive activities and to provide an incentive for modernization and growth of private industry (including that portion thereof which is regulated). If a regulated utility simply passed the benefits of an ITC to its ratepayers, Congressional intent underlying ITCs would be thwarted. Consequently, Congress passed rules, known as the "normalization rules," that prevented regulated utilities from immediately passing the benefit of ITCs along to its ratepayers. Under the election it previously made, the Company could not reduce its tax expense in cost of service faster than ratably over the life of the asset that generated the ITC and it could not reduce its rate base by the amount of ITC. The effect of these rules is that the utility could only pass the benefit of the ITC over time to its ratepayers as it depreciated its assets for book purposes.[7] If a utility violates these normalization rules, the utility forfeits its unamortized balance of ITC and is required to repay such ITC to the IRS.[8] The unamortized balance of a utility's accumulated ITC, therefore, represents the portion of ITCs the utility received which it has not yet shared with ratepayers.

Q. In general, why would the reduction of stranded costs by ITC constitute a violation of the normalization rules?

A. The normalization rules applicable to ITCs require the Company to reduce its tax expense element of cost of service no faster than ratably over the lives of the assets that

[7] *See* former Internal Revenue Code section 46(f)(2). See Figure RWH-R12
[8] Id.

produced the credits, and the Company cannot reduce its rate base by the accumulated deferred ITCs. The credit can reduce tax expense no faster than "ratably." Regulation § 1.46-6(g)(2) defines "ratably" by reference to the regulatory depreciable life of the asset to which the credit relates.[9] Thus, the ITC can no longer be flowed back to the ratepayer once regulatory depreciation ends without violating the normalization rules.

Q. What is the sanction if the normalization rules are violated?

A. A violator of the normalization rules incurs a hefty penalty. If the Company is found to have violated the normalization rules, it must pay the IRS an amount equal to its current unamortized balance of accumulated deferred ITCs, not only on the generation property, but possibly on its transmission and distribution property also.

Q. Has the IRS addressed the application of the ITC normalization rules to a rate regulated company that has undergone deregulation?

A. Yes. The IRS first addressed these very issues when the telephone industry was being deregulated in the 1980s. In the first such ruling, the IRS concluded that the unamortized balance of accumulated ITCs may not be flowed back to ratepayers after deregulation.

In Private Letter Ruling (PLR) 8730013[10] (April 21, 1987) (See Figure RWH-R14), the IRS addressed a telecommunications utility that was being deregulated and whose regulated assets were removed from its regulatory books of account. The IRS held that:

> The normalization rules would be violated if the...ADITC's were left on the utility's regulatory books of account and flowed through to the

[9] Referencing former Internal Revenue Code sections 46(f)(1), (6). See Figure RWH-R12.
[10] Although Private Letter Rulings are applicable only to the taxpayers who requested them and may not be cited as precedent, they do reflect the thinking of the IRS on a given issue and are generally followed by the IRS on a consistent basis.

> ratepayers after the property to which they relate becomes deregulated. The normalization rules contemplate that the ADITC's will be flowed through ratably over the regulatory life of the assets to which they relate...Once property is deregulated it ceases to be public utility property as defined in section 167(l)(3)(A) of the Code. Said property is no longer depreciable for regulatory purposes and the tax reserves should be removed from the regulatory books of account....If the ADITC's relating to property that was deregulated were to remain on the regulatory books of account it would result in a violation of the requirements of section 46(f).

In the deregulation context, the IRS has concluded that when the assets are removed from the regulatory books of account, the ITCs cannot be flowed back to ratepayers without violating the normalization rules.

The company is in the exact same position as the telephone company in the above-cited Private Letter Ruling.

Q. Have any of the intervening or Staff witnesses relied on IRS Private Letter Rulings for their adjustments?

A. Yes. Mr. Kollen relies upon PLR 9852030 (see Figure RWH-R15) for the proposition that "ITCs could be used to reduce stranded cost" without a normalization violation. But Mr. Kollen's reliance on that ruling is misplaced because there is a key factual distinction between that case and the Company's. PLR 9852030 (and companion PLR 9852028) (see Figure RWH-R16) address the application of the normalization requirements during the rate freeze/rate cap set forth by California's electric industry deregulation statute and associated rate orders. I participated as a consultant to the two companies requesting the private letter rulings referenced above and attended the joint conference of right at the IRS National Office before the rulings were issued. Under the rate cap, it was intended that the utilities would have the opportunity to fully recover 100 percent of their generation-related sunk costs on a nonbypassable basis during a five-year transition period. The depreciable recovery periods for the two plants addressed were shortened from 16 and 28 years, respectively, to five years. The IRS held that a normalization violation would not occur if remaining ITC is amortized ratably over the *new five-year regulatory period* rather than over the previous periods of 16 and 28 years. The acceleration of ITC amortization permitted in PLRs 9852028 and 9852030 did not violate the normalization requirements because the lives of the related plant assets were reduced at the beginning of the transition period. The recovery of the California plant costs through regulated depreciation expense was not merely accelerated; instead, it resulted from a shortening of the lives of the entire plants (i.e., all unrecovered basis in the plants was recovered).

Thus, these PLRs support an acceleration of ITC amortization only when there is a reduction in the overall life of an asset. Such a reduction in life is not present in this case and thus this set of rulings cannot be used to justify the flowback of ITCs to ratepayers.

Mr. Kollen also cited PLRs 200004038 and 2000016020. (See Figures RWH-R17 and RWH-R18, respectively). I participated as a consultant to the company that requested the ruling that resulted in the issuance of PLR 200004038. My role as a consultant was to review the ruling request before it was filed with the IRS. Mr. Kollen stated that "LTR 200004038 and LTR 200016020 are instructive in the sense that the IRS stated that 'As a result of the sale, the reserves cease to exist' and 'Once the asset is sold, the regulatory life ceases to exist.' In other words, the reserves do not represent taxes that will be paid upon recovery of any competitive transition charge."[11]

Contrary to Mr. Kollen's suggestion, these rulings further confirm the fact that if ITCs are flowed back to ratepayers, a normalization violation would occur. In these rulings, the IRS held that the normalization rules would be violated under any one of the three following scenarios:

[11] Direct Testimony of Lane Kollen at 87.

1. For plants that are sold at a net after-tax book gain, a normalization violation would occur if the remaining unamortized accumulated deferred investment tax credits (ADITC) and EDIT benefits existing at the date of sale are incorporated in the gain on sale computation and returned to ratepayers through a Transition Cost Balancing Account ("TCBA").

2. For plants that are sold at a net after-tax book loss, a normalization violation would occur if the remaining unamortized ADITC and EDIT benefits existing at the date of sale are incorporated in the loss on sale computation and returned to ratepayers by amortizing those amounts to a TCBA.

3. Alternatively, if number two above is deemed to be a normalization violation, a proportionate part of the ADITC and EDIT benefits may not be returned to ratepayers without causing a normalization violation.

These rulings confirm the fact that if deregulation occurs by sale or otherwise and an unamortized ITC balance remains (as it does here), a normalization violation would occur if any amount of ITC (or excess deferred taxes) is flowed back to ratepayers.

Q. Has the IRS been consistent in its holdings contained in private letter rulings issued in the context of deregulation and taxable sales of public utility property?

A. Yes. The IRS has interpreted the normalization rules consistently over the years through numerous private letter rulings, all of which use the same logic and reach the same conclusion. In these rulings, the IRS has held repeatedly that upon deregulation the link between regulatory depreciation and ITC amortization is cut. Therefore, the flow of benefits to ratepayers must cease or the normalization rules will be violated. The IRS has never released a private letter ruling contrary to this position. While it is true that a private letter ruling is only binding against the IRS by the taxpayer who receives such ruling, this consistent line of authorities does reveal the IRS's interpretation of this matter and should be accorded deference by the Commission.

The IRS has not revoked any of these private letter rulings in question. When a private letter ruling has been revoked by the IRS, the IRS releases another private letter ruling with a statement to that effect. The Freedom of Information Act compels the IRS to disclose redacted copies of private letter rulings it issues. No ruling revoking any prior rulings on normalization violations in the context of deregulation and the taxable assets sales of public utility property have been issued. In fact, in an earlier proceeding before this Commission, Ms. Blumenthal suggested that the IRS had revoked these rulings. In response to a written inquiry on this subject, the IRS issued a letter confirming that it had not revoked such normalization rulings either as a group or individually as a plan to revoke the group of normalization rulings.[12]

Q. Both Mr. Effron and Mr. Kollen refer to certain regulations proposed by the IRS on March 4, 2003, that would allow the offset of ITC (and EDIT) against the recovery of stranded costs. Are you familiar with these proposed regulations?

A. Yes. The IRS did issue proposed regulations on March 4, 2003 which, if enacted in their current form, would reflect a change to the long-standing holdings of the IRS on normalization issues. (68 Fed. Reg. 10190-01; see Figure RWH-R19.) The proposed regulations provide that if a sale or deregulation occurs after March 4, 2003, the utility can continue to amortize its accumulated deferred ITC as if the assets had not been sold or deregulated. In other words, the utility would be able to flowthrough the ITC benefits to its ratepayers ratably over the original

[12] Docket No. 29206, TNMP's Motion to Supplement the Record (May 18, 2004), at Attachment B, which is attached hereto at Figure RWH-R22.

regulated life of the asset without violating the normalization rules. The proposed regulations also contain an election which, if implemented, would allow a utility to apply the regulations retroactively. The proposed regulations do not allow, however, a utility to immediately pass to ratepayers the current unamortized balance of accumulated ITC.

Q. Should the PUC follow the proposed regulations in this Docket?

A. No. Regulations that are proposed by the IRS have no effect until they become finalized. Since their release, the proposed regulations have been under heavy fire from many industry groups and tax experts. In particular, the attack has focused on the voluntary retroactive election provision of the proposed regulations. Not only have these proposed regulations been vigorously attacked, the IRS has been silent on the issue for nearly a year. If the regulations are finalized, in my view, based upon my conversations with the tax professionals who have been conferring with treasury personnel responsible for the finalization of the proposed regulations, there is a likelihood that they will not be enacted in the same form as the proposed regulations. In particular, the informal consensus of those tax professionals is that the final regulations will not allow a utility to apply the regulations retroactively. Without such a retroactive election, there is no doubt but that the position the Intervenors advance in this proceeding regarding an ITC offset would constitute a normalization violation because the deregulation of electric generation property in Texas occurred as of January 1, 2002, long before the proposed March 4, 2003 effective date of the proposed regulations. Due to the extreme uncertainty as to the form and status of regulations on this subject, the Commission cannot speculate as to the contents of any final regulations and cannot apply the proposed regulations in this true-up proceeding.

Q. Ms. Blumenthal and Mr. Tietjen also propose reducing the stranded cost recovery by ITC. Do their proposed adjustments violate the normalization rules?

A. Yes. Ms. Blumenthal proposes to reduce stranded costs by the grossed up amount of ITC. Mr. Tietjen proposes to reduce stranded costs by the present value of ITC. Based on the IRS private letter rulings regarding deregulation and the sale of assets, any amount of ITC flowed through to the ratepayer after deregulation or a taxable sale of assets would be a violation no matter how the amount is computed. Thus, the prior discussion concerning whether ITC may be given to the ratepayer after deregulation or a taxable sale of assets applies as well to the adjustment proposed by Ms. Blumenthal and Mr. Tietjen.

Q. If the proposed regulations were finalized in their present form and were deemed applicable to TGN's assets (even though the effective date of such regulations clearly indicate they would not apply), would either of Ms. Blumenthal's or Mr. Kollen's proposed offsets to the Company's recovery of stranded costs by ITC be allowed under such regulations?

A. No. Both Ms. Blumenthal and Mr. Kollen fail to compute the amount of the ITC offset in a manner that the proposed regulations would allow. The proposed regulations would not allow a utility to pass to ratepayers the current unamortized balance of accumulated ITC over the stranded cost recovery period if it is shorter than the original remaining life of the property, which would be the effect of each of their proposals. Thus, even if the proposed regulations were applicable (which they are not), neither proposal would be permissible.

Q. If the proposed regulations were finalized in their present form and were deemed applicable to TGN's assets (even though the effective date of such regulations clearly indicate they would not apply), would Mr. Tietjen's proposed offset to the Company's recovery of stranded costs by ITC be allowed under such regulations?

A. Yes. Mr. Tietjen proposes a computation of ITC offset that would comply with the proposed regulations.

Q. Are there further observations you have related to the testimony of intervenors and staff testimony related to the offset of ITC?

A. Yes. The following questions and answers relate to the specific observations I have regarding the direct testimony of Effron related to the offset of ITC.

Q. On page 15 of Mr. Effron's direct testimony, he states "The balance of ADITC realized but not yet amortized to income is reflected in Account 255 – Accumulated Deferred Investment Tax Credits. Because this balance represents the cumulative amount of reductions to income taxes not yet passed on to ratepayers, it is a balance of ratepayer supplied funds." Do you agree with this characterization?

A. No. As I describe above, ITC was created by the Internal Revenue Code and is, in effect, a grant from the federal government. It represents a tax benefit provided by the federal government that reduces income taxes otherwise payable. It is not a regulatory liability because it was not created by rate regulation and it was not supplied by ratepayers, but by the federal government.

Q. Mr. Effron's footnote 2 on page 19 states "It should be noted that TGN is now amortizing the ADITC on its books of account, although there is nothing to prohibit TGN from crediting the ADITC immediately to income and, thus, to equity." Do you agree with this assertion?

A. Absolutely not. APB 20, paragraph 16 (See Figure RWH-R20), prohibits TGN from taking the ITC into income. It states "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable. However, a method of accounting that was previously adopted for a type of transaction or event which is being terminated or which was a single, nonrecurring event in the past should not be changed. For example, the method of accounting should not be changed for a tax or tax credit which is being discontinued or for preoperating costs relating to a specific plant."

Q. On page 29 of his direct testimony, Mr. Kollen relies upon the ECOM Model valuation methodology under PURA § 39.302(5) to sustain his proposed offset of ITC against the Company's stranded cost recovery. Do you agree that PURA § 39.302(5) supports Mr. Kollen's position?

A. No. Stranded costs are determined by reference to market based valuations except in connection with nuclear assets that cannot otherwise be valued. Consequently, the contention that the ECOM Model's method supports an offset for ITC against stranded cost recovery is irrelevant and must be rejected.

EDIT

Q. Mr. Hriszko, let's turn now to excess deferred income taxes (EDIT). What is EDIT?

A. EDIT was created when the Tax Reform Act of 1986 lowered the corporate income tax rate from 46% to 34%. EDIT represents the excess of deferred taxes provided at 46% over the current tax rate (which is now 35%).

Q. Are there tax normalization rules attendant to EDIT?

A. Yes. Section 203(e) of the Tax Reform Act of 1986 recognized that certain utility commissions might reduce utility rates over a short period of time by flowing through to ratepayers the benefit of EDIT. (See Figure RWH-R13.) Thus, Section 203(e) provides a method, the Average Rate Assumption Method (ARAM), whereby EDIT is flowed back to ratepayers no more rapidly than as the timing difference related to accelerated depreciation reverses.

Q. What are the consequences if these normalization rules are violated?

A. The Company would lose the right to claim accelerated depreciation on all public utility property regulated by the PUC. This could include the transmission and distribution property of the Company.

Q. Has the IRS addressed the application of the EDIT normalization rules to a rate regulated company that has undergone deregulation?

A. Yes. The IRS has interpreted the EDIT normalization rules consistently over the years through numerous private letter rulings, all of which use the same logic and reach the same conclusion. For example, in PLR 8828005 (See Figure RWH-R23), the IRS extended its normalization violation holding applicable to ITC from PLR 8730013 (discussed on page 20 above) to include EDIT. The IRS held that:

> Where, as the result of deregulation legislation in States A through J, public utility property is removed from Affiliates' regulatory books of account, the entire deferred tax reserve attributable to such property, accumulated pursuant to section 167(1) and 168(e)(3) of the Code, including the 'excess tax reserve' as defined by section 203(e)(2)(A) of the Tax Reform Act of 1986, must also be removed from the regulatory books, and no final regulatory order may be used, directly or indirectly, to reduce Affiliates' rate base or cost of service (or treat it as no cost capital).

In PLR 200004038 (January 28, 2000), the IRS held that if a utility sells assets as a result of deregulation and continues to flow back the EDIT related to such assets, a normalization violation will occur. The IRS stated that:

> A violation of the normalization rules will occur if there is any return to ratepayers, after the sale date, of the unamortized excess deferred reserve attributable to accelerated depreciation on public utility property. Further, both ARAM and the Reverse South Georgia Method rely on mechanisms requiring a regulatory life. Once the asset is sold, the regulatory life ceases to exist.

PLR 200016020 (April 21, 2000) also involved a utility which sold its assets as a result of deregulation. Again, the IRS held that a "violation of the normalization rules will occur if there is any reduction to Subsidiary's rate base, after the acquisition date, for the unamortized EDIT reserve attributable to accelerated depreciation on public utility property."

In these rulings, the IRS has held that upon deregulation, the regulatory life of the asset is terminated and thus flowing through the EDIT related to such asset to ratepayers must cease or the normalization rules will be violated. The IRS has never released a private letter ruling contrary to this position. As I note above, while it is true that a private letter ruling is only binding against the IRS by the taxpayer who receives such ruling, this consistent line of authorities does reveal the IRS's interpretation of this matter and should be accorded deference by the Commission.

Q. Are the rules surrounding the normalization rules for ITC and EDIT similar?

A. Although the mechanics of flowing back ITC and EDIT under the normalization rules are different, they are often analyzed together in terms of potential violations of the rules. The IRS frequently analyzes the ITC and EDIT together in terms of potential violations of the normalization rules. Thus, much of my analysis of ITC is equally applicable to EDIT.

Q. Would this be true in analyzing the potential application of the proposed IRS regulations to EDIT?

A. Yes. My analysis of the proposed regulations on ITC is equally applicable to EDIT. Thus, for all the reasons stated regarding ITC, the proposed regulations should not be applied to allow an offset to stranded costs for EDIT.

Further, the proposed regulations would not allow a utility to pass to ratepayers the remaining balance of EDIT at a rate faster than the ARAM method would allow over the original life of the property as if it had not been deregulated. Of the adjustments proposed by Ms. Blumenthal, Mr. Kollen, Mr. Effron and Mr. Tietjen, only Mr. Tietjen's proposed adjustment would be permissible under the proposed regulations.

Q. Please summarize the adjustments proposed by Staff and Intervenors related to EDIT.

A. Ms. Blumenthal and Mr. Kollen propose an offset to stranded costs for the grossed up amount of EDIT, a proposal consistent with their proposal regarding ITC. Mr. Tietjen proposes an offset to stranded costs for the present value of the EDIT, a proposal consistent with his proposal regarding ITC. Mr. Effron proposes an offset to stranded costs for the grossed-up amount of EDIT, but does not present value the EDIT as he did with ITC.

Q. Should the PUC consider making any of these adjustments?

A. No. All of these proposed adjustments would violate the tax normalization rules if any EDIT is flowed though to the ratepayers no matter how it is calculated.

Q. On pages 16 and 17 of Mr. Effron's direct testimony, he develops an adjustment to net book value for state ADIT in the amount of $39,855,000 because he believes all such amounts are excess. In support of this adjustment, he states on page 20 that "deferred state income taxes represent amounts collected from ratepayers in excess of taxes actually paid." Do you agree with this statement?

A. No. It is my understanding that only Texas franchise taxes currently payable have been included in cost of service in past Company rate proceedings. Mr. Brian on page 15 of this direct testimony further explains that the recovery of current Texas franchise taxes has been on a one year lag. Accordingly, Mr. Effron's adjustment of $39,855,000 is inappropriate because these state ADIT amounts were never reflected in cost of service in rate proceedings.

VII. THE ADIT OFFSET TO REGULATORY ASSETS PROPOSED BY MS. BLUMENTHAL, MR. EFFRON AND MR. KOLLEN

Q. Ms. Blumenthal and Mr. Kollen propose to offset the Company's recovery of regulatory assets by ADIT. Could you explain the nature of these regulatory assets?

A. Yes. The regulatory assets to which Ms. Blumenthal and Mr. Kollen refer are those described by me in my direct testimony at pages 4-13.

Q. Do you agree with the adjustments proposed by Ms. Blumenthal and Mr. Kollen to offset regulatory assets by ADIT?

A. No. The premise on which both Ms. Blumenthal and Mr. Kollen rely is that ADIT is a regulatory liability. This premise is faulty. ADIT is NOT a regulatory liability. As stated previously in my testimony, regulatory liabilities are created out of the rate regulation process. Deferred taxes are not a result of rate regulation, but arise under the depreciation provisions of the Internal Revenue Code. Because deferred taxes are created under the Internal Revenue Code and must be paid to the federal government ADIT is not a regulatory liability.

Q. On page 94 of his direct testimony, Mr. Kollen states that upon the sale of Texas Genco, "the ADIT will reverse and be used to increase the income of Texas Genco and CenterPoint Energy, Inc., the parent Company." Do you agree with the characterization?

A. No. Whether ADIT will reverse or not depends upon the structure of the proposed sale transaction and whether it is a stock sale or an asset sale. If it is a stock sale, nothing inside Texas Genco changes. Texas Genco will continue to account for ADIT as if the stock sale did not take place; i.e., the ADIT will reverse as the book/tax temporary difference related to accelerated depreciation reverses. CenterPoint Energy will incur a large tax expense on such sale because of its lower tax basis in TGN stock.

If it is an asset sale, the point that Mr. Kollen overlooks is that the ADIT will reverse and to a significant extent, while ADIT will be reversed, it will not increase income of Texas Genco or CenterPoint Energy. It will increase taxes currently payable because TGN's net tax basis is significantly lower than its net book basis. This is, in effect, the payback of the interest free loan to the government.

Q. Both Ms. Blumenthal and Mr. Kollen refer to regulatory liabilities referenced either in the Company's 1998 SEC Form 10-K or in Docket No. 21665. If ADIT is

not a regulatory liability, what are the regulatory liabilities referred to in the Company's SEC Form 10-K and in the prior docket?

A. Ms. Blumenthal and Mr. Kollen have a basic misunderstanding of what comprises the Company's regulatory liabilities at December 31, 1998. The regulatory liabilities referenced in the Company's SEC Form 10-K and in the prior docket are for excess deferred income taxes on a grossed up (for tax) basis and for the deferred income taxes on investment tax credit on a grossed up (for tax) basis. These regulatory liabilities are not related in any way to the regulatory assets recorded for AFUDC or for the ADIT recorded on the regulatory assets associated with AFUDC.

Q. Should these regulatory liabilities be offset against the regulatory assets?

A. No. If these regulatory liabilities relating to excess deferred taxes and investment tax credit are offset against the regulatory assets, a normalization violation would occur. As stated previously in my testimony regarding offsetting ITC and EDIT against stranded costs, there would be a normalization violation if any amount related to ITC or EDIT is flowed through to the ratepayer after deregulation takes place.

Q. Deregulation in Texas was effective as of January 1, 2002. The recovery of regulatory assets is as of December 31, 1998. May any amounts related to ITC and/or EDIT be flowed through to ratepayers for the interim years of 1999, 2000 and 2001?

A. For years 1999, 2000 and 2001, the appropriate amounts of ITC and EDIT have already been amortized and flowed back to the ratepayer. If further amounts of ITC and/or EDIT are flowed back to the ratepayer as a reduction of regulatory assets, there would be, in effect, a decoupling of the tax benefits from the property that gave rise to the tax benefits and the flowback period would not be consistent with the amortization required by the tax normalization rules.

Q. While Mr. Kollen and Ms. Blumenthal propose that the Company's income tax related regulatory assets of $150.5 million be offset by the related ADIT to arrive at a net regulatory asset of zero, does Mr. Effron propose a similar adjustment?

A. Yes. While Mr. Effron does not adjust the regulatory asset of $150.5 million, he includes the ADIT related to the income tax related regulatory assets in his two ADIT adjustments totaling $1,242,642,000, which are discussed above in the ADIT offset section. The ADIT related to the income tax related regulatory assets is $141.2 million as of December 31, 2001, as shown on Exhibit DJE-2, page 3 of 6.

Q. Do you agree with Mr. Effron that the ADIT related to the regulatory assets should be offset against any recovery in this docket?

A. No. For all the reasons previously outlined in my testimony above on ADIT, ADIT does not represent a regulatory liability or funds collected from customers. Thus, it should not offset the recovery of stranded costs or regulatory assets.

Q. Mr. Kollen, Mr. Effron and Ms. Blumenthal all propose adjustments to the true-up amount related to the unamortized ITC on the Company's books as of December 31, 2001. Are there additional ITC related items which should be considered?

A. Yes. The Company has an income tax related regulatory asset related to the ITC basis reduction.

Q. How has the Company recorded the regulatory asset related to ITC basis reduction in the past?

A. The regulatory asset related to ITC basis reduction has historically been netted with the ITC regulatory liability for deferred taxes and the gross up on those deferred taxes. This was indicated by the Company in its response to COH 12-5

(See Figure RWH-R24), where the Company was asked to provide the detail of the tax regulatory liabilities as of December 31, 1998. The Company explained the regulatory liability for deferred taxes on ITC as follows: "This amount represents the regulatory liability for deferred taxes and the gross-up of deferred taxes on unamortized ITC, net of the deferred taxes and the gross-up of deferred taxes on the ITC basis reduction."

Q. Could you please explain what ITC basis reduction is?

A. Yes. For several years in the past, the Internal Revenue Code allowed ITC to be taken at a higher percentage rate with a tax basis reduction. For example, a 10% ITC was allowed with a 50% tax basis reduction. Alternatively, an 8% ITC was allowed with no basis reduction. The Company elected the higher ITC percentage with a tax basis reduction for a number of years.

Q. What implication does this have?

A. For tax purposes the tax basis of the asset is lower than the book basis because of the ITC basis reduction.

Q. How was this book/tax difference treated in past regulatory proceedings?

A. It is my understanding that it was treated similarly to Equity AFUDC and Debt AFUDC in past regulatory proceedings as a permanent item that increased tax expense when the ITC basis reduction book basis is depreciated. ITC basis reduction was not treated as a permanent item subsequent to December 31, 1998, consistent with the treatment of all other income tax related regulatory assets that were frozen at the December 31, 1998 amounts.

Q. How much is the ITC basis reduction regulatory asset as of December 31, 1998?

A. This amount is $33.9 million. It is included in the net ITC regulatory liability of $95.0 million as of December 31, 1998.

Q. How should this regulatory asset be taken into consideration in the true-up proceeding?

A. As I have stated, the Company has always reflected the ITC regulatory liability on a net basis. If the Commission determines that ITC should be netted against regulatory assets or otherwise offset against the true-up amount, then the regulatory asset related to ITC basis reduction should be added to the $150.5 million of income tax regulatory assets included on Schedule VIII-B attached to my direct testimony.

Q. On page 93, Mr. Kollen proposes to reduce regulatory assets by the $30.945 million adjustment made by the Company to reflect the PUC order in Docket No. 22355. Do you agree?

A. No. The Order in Docket No. 22355 was retroactive in nature and required the Company to reverse its 1998 additional and redirected depreciation. To be consistent with the Order in Docket No. 22355, the $30.945 million adjustment must be made to determine the appropriate December 31, 1998 regulatory asset balances.

Q. Does this conclude your testimony?

A. Yes, it does.

AFFIDAVIT

STATE OF ILLINOIS

COUNTY OF COOK

BEFORE ME, the undersigned notary public, this day personally appeared Robert W. Hriszko, to me known, who being duly sworn according to law, deposes and says:

"My name is Robert W. Hriszko. I am of legal age and a resident of the State of Illinois. The foregoing testimony and the opinions stated therein are, in my judgement and based upon my professional experience, true and correct."

Robert W. Hriszko

Robert W. Hriszko

Subscribed and sworn before me on this 10th day of June 2004.

Linda S Young

Notary Public in and for Cook County, Illinois

OFFICIAL SEAL
LINDA S YOUNG
NOTARY PUBLIC, STATE OF ILLINOIS
MY COMMISSION EXPIRES:03/12/06

My Commission expires:

3/12, 2006

FIGURE RWH-R1

Statement of Financial Accounting Standards No. 109, No. 125

Statement of Financial Accounting Standards No. 109

FAS109 Status Page
FAS109 Summary

Accounting for Income Taxes

February 1992

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

effect, in the seller's tax jurisdiction, of any reversing temporary differences as a result of that intercompany sale are deferred. The Board believes that that decision together with the decisions for Statement 52 and certain Opinion 23 differences should eliminate the need for complex cross-currency deferred tax computations for most enterprises.

Regulated Enterprises

125. When Statement 71 was issued, accounting for income taxes was a project on the Board's agenda, and the Board decided not to change regulated enterprises' accounting for income taxes until that project was completed. The general standards of accounting for the effects of regulation set forth in Statement 71 require recognition of a deferred tax liability or asset for the tax consequences of temporary differences because a regulator cannot relieve a regulated enterprise of a liability or asset that was not created by rate actions of the regulator. Those general standards require (a) recognition of an asset when a deferred tax liability is recognized if it is probable that future revenue will be provided for the payment of those deferred tax liabilities and (b) recognition of a liability when a deferred tax asset is recognized if it is probable that a future reduction in revenue will result when that deferred tax asset is realized. The Board concluded that this Statement should be applied to regulated enterprises consistent with the general standards of accounting for the effects of regulation set forth in Statement 71.

Leveraged Leases

126. The Board acknowledges that the accounting for income taxes related to leveraged leases set forth in Statement 13 and Interpretation 21 is not consistent with the requirements of this Statement. However, the Board concluded that it should not change the accounting for income taxes related to leveraged leases without considering the need to change leveraged lease accounting, and decided not to reopen the subject of leveraged lease accounting as part of this project. Therefore, this Statement does not change the requirements of Statement 13 or Interpretation 21. The Board also considered whether there should be any integration of (a) the results of accounting for income taxes related to leveraged leases with (b) the other results of accounting for income taxes as required by this Statement. Integration is an issue when all of the following exist:

(1) The accounting for a leveraged lease requires recognition of deferred tax credits.
(2) The requirements of this Statement limit the recognition of a tax benefit for deductible temporary differences and carryforwards not related to the leveraged lease.
(3) Unrecognized tax benefits in (b) could offset taxable amounts that result from future recovery of the net investment in the leveraged lease.

The Board concluded that, in those circumstances, integration should be required. However, consistent with the decision not to change leveraged lease accounting, the Board decided that integration should not override any results that are unique to income tax accounting for leveraged leases, for example, the manner of recognizing the tax effect of an enacted change in tax rates.

FIGURE RWH-R2

Annex to the Statement of Emil M. Sunley, March 28, 1979

Accounting for Tax Subsidies with Special Reference to Cost of Service, or "Fair Rate of Return", Utility Regulation

An Annex to the Statement of
Emil M. Sunley
Deputy Assistant Secretary (Tax Analysis)
Department of the Treasury
Before the
Oversight Committee of
The Committee on Ways and Means
March 28, 1979.

continue to maintain its rate base, the $94.3 million of interest-free loans will be sustained by the equivalent of "rolling-over" outstanding private bonds: Loan repayments will be covered by new borrowing.

The ultimate effect of the Commerce Department lending program has been to reduce the unsubsidized financing of $465 million required to sustain a $465 million rate base to only $370.7 million, with consequent reductions in the cost of service. The effects on cost of service resulting from the subsidized financing program are tabulated in columns (5)-(9) of Table A-7. Since the subsidy does not reduce the private cost of purchasing plant and equipment, the $30 million annual depreciation cost of service remains unaffected. However, the interest paid, income tax, and after-corporate-tax return to equity steadily declines as Federal interest-free financing grows. Ultimately, since the private financing required is reduced by 20.3 percent, the portions of cost of service relating to returns to private capital similarly decline, and this brings about a 5.9 percent reduction in total cost of service, from $274.57 million to $258.43 million.

Clearing the interest-free loan program through the income tax.

The lending program just described required the Commerce Department to write checks in exchange for private firms' notes agreeing to the terms of the loan, including repayments. Once again, the necessity for writing checks to implement the financing subsidy program can be avoided by clearing the government lending through the income tax accounts of investors. Indeed, this has been done. In 1954, all taxpayers were allowed to use formulas for determining annual depreciation allowances that include the sum-of-years'

digits method and others consistent with it, whether or not this matched the real depreciation pattern of assets. Beginning in 1971, taxpayers have been allowed to use 80 percent of the guideline life for such assets published by the Treasury Department, regardless of the economic lives of their assets. In certain other cases, Congress has explicitly introduced 5-year write-offs and immediate expensing privileges that are the functional equivalents of interest-free lending programs described above.

It will be recalled that the magnitude of the interest-free loans is dependent on the difference between the "proclaimed" schedule of depreciation allowances and that which would be used for actual income measurement. This characteristic of the lending program raises certain issues concerning the "norm" of depreciation imputation that should be used for "actual" income measurement, a matter to which we will turn below. However, in the regulated company case, as has been noted above, the depreciation imputation norm is specified and validated by regulatory commission rate making rules.

Thus, to the extent that taxable income of utilities is measured with the use of depreciation imputation rules that depart from those used by regulatory commissions, the Federal government is implementing an interest-free lending program of the type just described. Prior to the modifications of the tax laws beginning in 1954, there was reasonably close correspondence between the regulatory and tax rules governing depreciation imputation. In regulated industries, therefore, the post-1954 deviations of tax rules for income measurement from regulatory norms marked the introduction of a subsidy program that may only be correctly accounted for as a source of interest-free loans.

We may translate the discussion above of an accounting for the effect of interest free Federal financing into the terminology of regulatory accounting for tax expense as follows: Attendant on investment in depreciable assets is the need to measure pre-tax income flowing from their use, after making allowance for the ultimate worthlessness of those assets due to wear-and-tear and to obsolescence. Whatever formula is used for imputing the occurrence of this decline in value over the life of the assets in order to measure taxable income, the same total imputation will be made for regulatory purposes. If the tax rules result in larger depreciation imputations early in the lives of assets than is imputed under regulatory rules, then tax depreciation imputations for the same assets will be smaller later in the assets' lives. In effect, the entries in Table A-6 measure the time-displacement of tax payments--"tax deferral"--not a "forgiveness" of tax. Since income tax is a statutory percentage of income, and income is a function of the privately financed capital used to produce service by the regulated company, then if, and only if, the regulatory commission computes tax expense--an element of cost of service--by using its own depreciation imputation rules will it measure and fairly distribute the cost of capital services over time. "Tax deferral" represents interest free borrowing, the benefits of which will be distributable to customers as the loans, generally called "deferred taxes", displace private financing.

This accounting procedure is called "normalization" of the difference between income tax liability, the current year tax expense, using the company's depreciation imputation rules (the regulatory commission's rules in the case of a regulated company) and that using the tax depreciation imputation rules. The tax liability computed using the regulated company's own rules, since it is purely a function

of the tax rate applied to an income measure based on the value of assets employed, and which are privately financed, is the correct measure of income tax expense for the period; the difference, "deferred taxes" is a source of financial funds available (and used) to displace private financing.

The financial statements for 1979 that reflect this procedure are shown in Table A-8. The only difference between these statements and those of the base case for the same year (Table A-1) is the $0.64 million ($644,000, rounded) of deferred tax: In the income statement reflecting the first-year lending program, tax expense of $23.77 million is presented in two parts, the net $23.13 million payable after netting the $0.64 million of interest free loan plus the loan proceeds for the year itself, labelled "deferred tax"; in the end of 1979 balance sheet, deferred tax appears on the liability side, offset on the asset side by an equivalent $0.64 million of cash and other current assets. This raises total assets and liabilities to $565.64 million at the end of 1979. When the $0.64 million is used to reduce debt and equity, at the beginning of 1980, the asset and liability totals will revert to $565 million. This process of displacing private financing of the rate base shown in Table A-7 to reflect the accumulation of interest- free loans can occur, of course, only if the regulatory commission properly regards the total tax expense, computed on the basis of its own depreciation imputation rules and also shown in Table A-7, as a cost of service. Assuming prompt regulatory response, this normalization procedure to account for the effects of an interest-free lending program charges each year's customers their true (private) cost of service, as this has been reduced by the volume of interest-free lending by Federal taxpayers.

4

Figure RWH-R2

FIGURE RWH-R3

Statement of Daniel L. Halperin, April 15, 1980