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APPLICATION OF CENTERPOINT ENERGY HOUSTON ELECTRIC, LLC FOR AUTHORITY TO CHANGE RATES	**§ § §**	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

May 15, 2019

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To: Accounting Files
From: Jeff Hunt
Date: April 2010
RE: Q1 2010 Impact on CNP due to the Enactment of Health Care Reform

Background

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act, which was subsequently amended on March 30, 2010 when President Obama signed the Reconciliation Act of 2010 (collectively the "Act"). Among other provisions, the Act eliminates the tax deduction for the Medicare Part D Subsidy (Subsidy) received by CenterPoint Energy Corp. (CNP).

An employer offering retiree prescription drug coverage that is at least as valuable as Medicare Part D coverage is currently entitled to a federal retiree drug subsidy. In 2006, CNP's plan was determined to be at least as valuable. Prior to the Act, employers could claim a deduction for the entire cost of providing the prescription drug coverage even though a portion of the cost is offset by the subsidy they receive. The Act repeals the current rule permitting deduction of the portion of the drug coverage expense that is offset by the Medicare Part D subsidy. This provision of the Act is effective for taxable years beginning after December 31, 2012.

An employer's promise to provide postretirement prescription drug coverage is recorded as a component of the other postemployment benefit (OPEB) obligation in accordance with ASC 715. When that coverage benefit meets certain criteria, the employer becomes eligible to receive the federal retiree drug subsidy, which is then recorded as an offset against the obligation (the obligation is recorded net of the subsidy, and the net amount is actuarially determined). In determining the deferred tax asset related to the OPEB obligation, companies have been required to "unbundle" this net amount into the "pre-subsidy" liability and the offsetting subsidy receivable. Because the obligation has historically been deductible for the full amount paid (i.e., the deduction was not reduced by the subsidy), a deferred tax asset has historically been recorded for the future tax deduction related to the pre-subsidy amount of the obligation. The subsidy receivable has not required a deferred tax liability because it has not been taxable when received. The change in law does not actually affect the taxation of the subsidy itself. Instead, the subsidy received will reduce the tax deduction for the cost for OPEB, which effectively become taxable. Therefore, the expected future tax deduction will be reduced by an amount equal to the subsidy, and the corresponding deferred tax asset must be reversed.

As shown in the analysis provided by Hewitt (see Attachment A) the total amount of the deferred tax asset to be reversed was estimated to be $46 million. This amount was based off of $132 million of benefit payments that will no longer be deductible and an estimated tax rate of 35%. However, this amount does not represent the effect of regulatory accounting as discussed below.

Purpose

The purpose of this memo is to document the accounting implications of the Act related to Q1 2010.

Issue #1

What is the proper accounting for the reversal of the deferred tax asset previously recognized for the tax deductibility of future benefit payments, which payments no longer will be tax deductible?

Discussion

In regards to changes in tax laws or rates, ASC 740-10 states the following:

25-47 The effect of a change in tax laws or rates shall be recognized at the date of enactment.

35-4 Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. A change in tax laws or rates may also require a reevaluation of a valuation allowance for deferred tax assets.

45-15 When deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date.

Since the Act was signed in Q1 2010, the impact of the lost tax deductibility for future benefit payments should also be recognized in that same period. The amount of the impact to be recorded is calculated by using the "with and without" method. For book purposes, the OPEB liability continues to be recorded "with" the projected Subsidy related to the future benefit payments. Prior to the Act, the basis for tax purpose had been calculated "without" the projected Subsidy because the Subsidy was not taxable. With the Act, the basis of tax purposes will be "with" the projected Subsidy because the subsidy becomes effectively taxable. The difference between "with" and "without" the projected subsidy represents the eliminated deductible temporary difference for which CNP needs to write off the associated deferred tax asset.

The difference between "with" and "without" the projected subsidy is $143 million, which represents the present value of the Subsidy to be received over the life of the plan. This amount differs from the $132 million stated above. The $11 million difference is the total estimated amount of the Subsidy to be received in 2010, 2011, and 2012, which subsidies will not be applied against benefit payments for those years as this provision in the Act does not go into effect for CNP until the 2013 tax year.

Using the "with and without" method, we calculated that the total impact to continuing operations would be $21 million. The reconciliation from the $132 million to the $21 million is shown in the table below (See Attachment B for full details on the calculations related to the entry):

Present value of the Subsidy (from Hewitt report)	132.2
Estimated change in DTA (Hewitt esetimated using 35% rate)	46.3
Adjustment to Hewitt estimate using actual composite tax rate	1.9
DTA related to the Subsidy	48.2
DTA related to the Subsidy regulatory asset	-16.5
Actual change in regulatory asset	-10.6
One-time account charge included in income tax expense	21.1

DTA related to the Subsidy

The total amount of the regulatory asset recorded on the books related to the OPEB plan is $51.9 million. This regulatory asset represents only the book basis and does not have a tax basis. Said another way, the $51.9 million regulatory asset is offset by the same amount recorded in the OPEB liability, both of which represent temporary tax differences. The Subsidy balance that relates to these regulated entities is $45.9 million, giving the "without" method a regulatory asset in the amount of $97.8 million for tax. The $45.9 million additional regulatory asset related to the Subsidy also has no tax basis and thus there is no deferred tax asset recorded in relation to this balance, or said another way, any deferred tax asset recorded on this balance is offset by the same amount of deferred tax liability thus the write off of both of those balances results in a net effect of $0. Thus in calculating the impact on the income statement from the change in tax treatment caused by the Act, the tax effect of the DTA related to the Subsidy regulatory asset should not have an impact on the income statement. This amount is then subtracted from the DTA related to the Subsidy in calculating the impact on the income statement. The total amount subtracted is the $45.9 million multiplied by the composite tax rate for the affected entities (which rate is lower than the CNP composite rate as the majority of the balance is related to CEHE where OPEB cost is not subject to the Texas margin tax), giving a total amount to be subtracted of $16.5 million.

Actual change in regulatory asset

In accordance with pension and OPEB accounting, the unrealized gain/loss on these liabilities is recognized ratably over time. Upon adoption of FAS 158 companies were required to record the actuarially determined asset or liability related to pension and OPEB benefits, which then required companies to record the unrealized gain/loss with the offset to AOCI. During the implementation of FAS 158, there was uncertainty as to how a regulated company that was recovering its pension and OPEB costs through rates would adopt the standard. It was determined that a regulated company that was recovering through rates pension and OPEB costs that were determined based on a FAS 87/106 expense model would be allowed to record the offset of the FAS 158 entry to a regulatory asset/liability instead of AOCI, if all other requirements for a regulatory asset/liability were met. This treatment was further solidified when the FERC issued docket no. AI07-1-000, *Commission Accounting and Reporting Guidance to Recognize the Funded Status of Defined Benefit Postretirement Plans*, which stated:

> Under the Commission's accounting requirements, regulatory assets or liabilities are to be established for amounts that would have been included in net income or accumulated other comprehensive income determinations in the current period under the general requirements of the Uniform Systems of Accounts but for it being probable that such items will be included in a different periods(s) for purposes of developing rates that the utility is authorized to charge for its utility services.
>
> Therefore, in the circumstances described above and provided that it is probable that the postretirement benefit allowance to be included in rates in future periods will continue to be calculated on the basis of SFAS No. 87 and SFAS No. 106, entities shall recognize a regulatory liability or asset for the funded status asset or liability otherwise chargeable to accumulated other comprehensive income under SFAS No. 158 related to its cost-based, rate-regulated business segments.

It was determined that CNP had two entities that met the qualifications for recognition of a regulatory asset or liability under FAS 158. These entities were CEHE and Minnegasco, as they both collect through rates their pension and OPEB expense on a FAS 87/106 basis. These entities also include in their rates the tax effects of the pension and OPEB costs, which means that their next rate filings will be affected by the Act since the loss of the tax benefit will be included in the calculation of the pension and OPEB expense. Thus CNP believes it is probable that rates for both CEHE and Minnegasco will increase based on the increase taxes caused by the Act.

The rationale for setting up a regulatory asset is due to the fact that the tax benefit was included in the rate calculation for the years prior to 2010. This loss of benefit was therefore not collected from customers during those prior years as the amount collected from customers for taxes was based off of the pre-Act taxes. For a detailed example showing how the tax benefit was not collected through rates, see Attachment D.

On this note, ASC 980-740 states the following:

25-1 For regulated entities that meet the criteria for application of paragraph 980-10-15-2, this Subtopic specifically:
- a. Prohibits net-of-tax accounting and reporting
- b. Requires recognition of a deferred tax liability for tax benefits that are flowed through to customers when temporary differences originate and for the equity component of the allowance for funds used during construction
- c. Requires adjustment of a deferred tax liability or asset for an enacted change in tax laws or rates

25-2 If as a result of an action by a regulator, it is probable that the future increase or decrease in taxes payable for (b) or (c) in the preceding paragraph will be recovered from or returned to customers through future rates, an asset or liability shall be recognized for that probable future revenue or reduction in future revenue pursuant to paragraphs 980-340-25-1 and 980-405-25-1. That asset or liability also shall be a temporary difference for which a deferred tax liability or asset shall be recognized.

In addition to the above paragraph, PwC issued guidance in its 2009 Guide to Accounting for Income Taxes (PwC Guide) which states the following in Section 9.2.2:

> In the case of deferred tax liabilities that represent amounts recovered currently as deferred income tax expense from customers (in the period that such temporary difference arises) for future payment of income taxes, a corresponding regulatory asset will not be recorded. However, when there is a rate change and it is probable that amounts will be recovered as a result of an increase or decrease in future revenue requirements, a regulatory asset (or liability) should be recorded.

In addition to the guidance in PwC Guide, PwC also presented the following guidance as part of its Q1 Utilities Executive Webcast:

- Our current perspective on regulatory accounting:
  - For regulated entities, the accounting for the Medicare Part D adjustment should follow the original account for FAS 158
    - If the offset was to a regulatory asset, the Medicare part D adjustment would be recorded to the regulatory asset
    - If the offset was to AOCI, ASC 740 requires that this adjustment is recorded as a charge to income
      - A regulated entity may decide to seek regulatory recovery of this on-time charge
      - If management has enough evidence to support that it is probable that the entity will specifically recover the Medicare Part D subsidy in future rates, this adjustment may be recorded as a regulatory asset

Based on the citations presented above, the FASB guidance as well as the guidance presented by PwC indicates that at a minimum, the part of the write-off amount attributed to entities that record the FAS 158 adjustment to a regulatory asset instead of AOCI should be capitalized as a regulatory asset to the extent it meets all other qualifications for a regulatory asset.

The qualifications for recognizing a regulatory asset are listed in ASC 980-340 as follows:

25-1 Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

a. It is probable (as defined in Topic 450) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.

b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

A cost that does not meet these asset recognition criteria at the date the cost is incurred shall be recognized as a regulatory asset when it does meet those criteria at a later date.

The tax benefit that is being written off was not recognized in cash as it represents a tax benefit on future OPEB expenditures; however, it was recognized in accordance with US GAAP and OPEB accounting rules. Even though it has not been recognized in cash, it is an incurred cost as it has been recorded in the accounting ledger. An incurred cost has been defined in a footnote to FAS 71 paragraph 9 (now ASC 980-340-25-1) which states:

> An incurred cost is "a cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for"

The taxes on the OPEB plan have been recognized to the extent the liability has been recognized. Thus, when the Act was signed into law, the value of the deferred tax asset related to the OPEB plan was decreased. This deferred tax asset represents expenditures that will be deductible in the future when the cash is actually paid. However, the benefit has been recognized in accordance with US GAAP, and is thus an incurred benefit. The loss of the tax benefit therefore results in an incurred cost that is capitalizable as a regulatory asset under ASC 980-340. As mentioned above, CNP believes it is probable that this regulatory asset will be included in rates in future rate filings.

We noted that since CEHE and Minnegasco qualify for this treatment under FAS 158 and it is at least probable that the loss in tax benefit will be included in the next rate filing, capitalizing the amount of the write-off as a regulatory asset for both CEHE and Minnegasco would be appropriate under US GAAP. We noted that the total amount of the write-off attributable to these entities is $10.6 million in total, which explains this item in the table above.

Also in accordance with ASC 740 which prohibits net-of-tax accounting, a tax gross-up amount is required to be recorded on the regulatory asset balance of $10.6 million. This tax gross-up amount equals the extra amount of revenue that would be required to fully collect the $10.6 million. We calculated the gross-up amount to be $6.0 million, which will be added to the regulatory asset with the offset being recorded to a deferred tax liability. Both the regulatory asset and the deferred tax liability will be amortized over the expected collection period of the anticipated increased rates.

The result of the above items is a $21.1 million impact on the income statement related to the elimination of the tax benefits related to the Subsidy. As noted in ASC 740-10-45-15 above, the total impact of $21.1 million is to be included in continuing operations in the period of the enactment date. This amount will therefore be included in the Income Tax Expense line item on the income statement for Q1 2010.

Issue #2

How should the disproportionate tax effect that is lodged in AOCI be cleared?

<u>Discussion</u>

Pursuant to the guidance in ASC 740 that requires the income tax charge to be recognized in continuing operations in the period of enactment, the charge taken to the income statement does not take into account the fact that a portion of the $21.1 million is recorded in AOCI pursuant to pension and OPEB accounting guidance. The write-off amount therefore results in a balance that will be disproportionately lodged in AOCI. We calculated that of the $21.1 million write-off, $13.1 million of was included in AOCI and therefore is disproportionately lodged in AOCI with no underlying basis. This amount needs to therefore be cleared out of AOCI.

We noted that ASC 740 is silent as to the method to be used to clear out disproportionate tax effects from AOCI. We did note the following per section 12.2.3.2.2.3 in the PwC Guide:

> We believe that the OCI balance must be eliminated when the circumstances upon which it is premised cease to exist (which usually would result when the items that gave rise to the disproportionate tax effect were "reclassified" to continuing operations under ASC 220). Presumably, the pretax items in OCI ultimately will be cleared to income (perhaps in an indefinite, distant future period).

The PwC guidance suggests that a company use either an item-by-item approach or an aggregate portfolio approach. The latter would not require the lodged balance to be cleared unless the entire underlying asset or liability is completely removed. In the case of the Subsidy related lodged item under this method, this item would stay in OCI until the OPEB liability is completely eliminated. This approach does not seem to be the best approach given that the lodged balance could stay in OCI indefinitely and this would not reflect the substance of the lodged item.

Instead, it would be more appropriate to use the item-by-item approach, which would result in the lodged item being cleared out of OCI as the related unrealized gain/loss is amortized into earnings. As the amortization period of current unrealized gain/loss items under OPEB accounting is approximately 13 years (see Attachment C), which is equal to the estimated remaining service period for plan participants, we will amortize this lodged balance over 11 years. This will result in an income tax benefit of just over $1 million per year related to the amortization of this balance.

Attachments

Attachment A – Hewitt's Analysis of the Impact of the Acct
Attachment B – Medicare Subsidy Workpapers and Entry Support
Attachment C – Average Remaining Service Life
Attachment D – Tax Impact Example of the Act

CenterPoint Houston
History of OPEB Expense, Medicare Part D Subsidy
Medicare Part D Receivable
(Dollars in thousands)

	2012	2013	2014	2015	2016	2017	2018	Cumulative
ASC 715 Expense (with Subsidy)								
Expense Percentage	53 13%	47 36%	48 43%	47 36%	47 68%	43 73%	45.45%	
Capital and Other Percentage	46.87%	52 64%	51 57%	52.64%	52 32%	56 27%	54 55%	
Expense Allocation	$ 10,022	$ 7,761	$ 5,717	$ 4,556	$ (545)	$ 1,032	$ 716	$ 29,259
Capital and Other Allocation	$ 8,841	$ 8,627	$ 6,088	$ 5,063	$ (597)	$ 1,328	$ 859	$ 30,209
Medicare Part D Permanent Item	18,863	16,388	11,805	9,619	(1,142)	2,360	1,575	59,468
Less Part D Cash Receipts	(1,717)	(1,455)	(1,380)	(1,333)	(1,416)	(12)	(81)	(7,394)
Total Medicare Part D Receivable								52,074

CERTIFICATE OF SERVICE

I hereby certify that on this 15th day of May 2019, a true and correct copy of the foregoing document was served on all parties of record in accordance with 16 Tex. Admin. Code § 22.74.

Martin Brun