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

REBUTTAL TESTIMONY

OF

JENNIFER K. STORY

ON BEHALF OF

CENTERPOINT ENERGY HOUSTON ELECTRIC, LLC

July 12, 2024

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REBUTTAL TESTIMONY OF JENNIFER K. STORY

I. INTRODUCTION

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

A. My name is Jennifer K. Story. I am the Vice President of Tax for CenterPoint Energy Service Company, LLC, an indirect, wholly owned subsidiary of CenterPoint Energy, Inc. ("CNP"). My business address is 1111 Louisiana Street, Houston, Texas 77002.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

A. I am testifying on behalf of CenterPoint Energy Houston Electric, LLC ("CenterPoint Houston" or the "Company").

Q. ARE YOU THE SAME JENNIFER K. STORY THAT FILED DIRECT TESTIMONY IN THIS DOCKET?

A. Yes.

II. PURPOSE OF REBUTTAL TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. In my rebuttal testimony, I respond to arguments presented in the direct testimonies of Lane Kollen on behalf of Gulf Coast Coalition of Cities ("GCCC"), Steven D. Hunt on behalf of Houston Coalition of Cities ("HCC"), Kyra Coyle on behalf of the Office of Public Utility Counsel ("OPUC"), and Jeffry Pollock on behalf of the Texas Industrial Energy Consumers, or collectively referred to as intervenors. In addition, I address arguments made by Public Utility Commission of Texas ("Commission") Staff witness Ruth Stark. I also discuss the attendant impacts to federal income taxes for any accepted adjustments to the Company's revenue requirement.

Q. HOW DOES YOUR REBUTTAL TESTIMONY RELATE TO THE REBUTTAL TESTIMONY OF OTHER WITNESSES WHO ARE COVERING RELATED TOPICS?

A. In her rebuttal testimony, Company witness Kristie L. Colvin addresses certain rate base adjustments proposed by intervenor witnesses. I discuss the attendant impacts of those adjustments to federal income taxes. Ms. Colvin and Company witness John R. Durland address the proposed Rider related to the Inflation Reduction Act ("IRA") in their testimonies while I discuss the underlying tax impacts of the IRA.

Q. WAS THIS REBUTTAL TESTIMONY PREPARED BY YOU OR UNDER YOUR DIRECT SUPERVISION AND CONTROL?

A. Yes.

Q. WERE THE EXHIBITS LISTED IN THE TABLE OF CONTENTS PREPARED UNDER YOUR DIRECTION, SUPERVISION AND CONTROL?

A. Yes.

Q. PLEASE DESCRIBE THE TAX CHANGES MADE IN THE COMPANY'S ERRATA FILINGS.

A. As noted in the rebuttal testimony of Ms. Colvin, the Company filed errata on May 22, 2024, and on June 14, 2024, that incorporated certain adjustments that were identified during the discovery process. As these issues were identified in response to discovery requests, the Company included an explanation and provided functioning Excel workbooks, where applicable, within the discovery responses that reflected the necessary revisions. Certain errata included adjustments to

Accumulated Deferred Income Taxes ("ADIT") for the net operating loss carryforward ("NOLC") and certain rate base items. My rebuttal testimony reflects the results of these errata filings.

III. THE INFLATION REDUCTION ACT

A. CAMT Credit Carryforward

Q. PLEASE DESCRIBE HOW A CORPORATE ALTERNATIVE MINIMUM TAX ("CAMT") CARRYFORWARD IS CREATED AND RECORDED ON THE COMPANY'S BOOKS AND RECORDS.

A. As described in my direct testimony, a CAMT credit carryforward is generated when a taxpayer pays CAMT. This credit carryforward can be utilized in future years to offset income tax liabilities in periods where the regular federal income tax liability exceeds the CAMT liability.[1] Like all other tax carryforwards, the CAMT carryforward is recorded as a deferred tax asset ("DTA") on the Company's books. When CenterPoint Houston generates a CAMT liability in the future, the CAMT credit carryforward will be recorded on CenterPoint Houston's books and will be used in the future to reduce CenterPoint Houston's regular tax liability.

Q. HAS THE COMPANY INCLUDED A CAMT DTA IN RATE BASE IN THIS FILING?

A. No. The test year for this filing is year-end December 31, 2023. While preparing year-end estimates for 2023 federal income taxes, the Company did not believe that it would be required to pay CAMT with the 2023 tax return.

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[1] Direct Testimony of Jennifer K. Story ("Story Direct") at 1058:1-3 (bates stamp) (Mar. 6, 2024).

Q. DO YOU BELIEVE THAT THE COMPANY WILL HAVE A CAMT OBLIGATION IN THE FUTURE?

A. Yes. In fact, the Company is currently accruing a CAMT liability for the 2024 tax year. Therefore, the Company will have a CAMT credit carryforward DTA for the amount of the liability.

Q. WHY DOES MR. KOLLEN APPEAR TO BELIEVE THAT CENTERPOINT HOUSTON WOULD NOT BE AN APPLICABLE CORPORATION AND SUBJECT TO CAMT IF IT WERE NOT INCLUDED IN CNP'S CONSOLIDATED INCOME TAX RETURN?

A. Mr. Kollen argues that the tax is imposed on CNP, not CenterPoint Houston; therefore, the Company, according to Mr. Kollen, is not subject to the CAMT.

Q. IS MR. KOLLEN CORRECT?

A. No. CenterPoint Houston's requirement to pay CAMT is a matter of law and CenterPoint Houston's inclusion in the consolidated federal income tax return is not relevant. As I explain in my direct testimony, the determination of whether a corporation is an Applicable Corporation under federal tax law is made by looking at the Adjusted Financial Statement Income ("AFSI") for the previous three years. A corporation and other members of a single employer group are generally considered Applicable Corporations for a taxable year, and all subsequent taxable years, if average annual AFSI for the three preceding years of this corporation, and other members of single employer group exceeds $1 billion. For this purpose, an Applicable Corporation (i.e., member of a single employer group) is an entity under a single employer as defined by Internal Revenue Code ("I.R.C.") § 52(a) or (b) that meets the parameters of the AFSI test. The entity need not itself meet the AFSI test but only be a part of the single employer that does.[2] CenterPoint Houston's AFSI for purposes of the AFSI test is that of the single employer (CNP) and not CenterPoint Houston's own AFSI. CenterPoint Houston assumes the single employer group's (CNP's) AFSI as its own AFSI for the test. Because CenterPoint Houston is part of a single employer subject to CAMT, CenterPoint Houston would be subject to CAMT even if it were NOT included in the CNP federal consolidated income tax return. Likewise, if the Company ceases to be a member of the single employer group, it would be entitled to its CAMT credit carryforward and can use the credit in future years when regular tax exceeds its CAMT liability.

Q. WHAT IS THE IMPACT OF THE COMPANY'S CLASSIFICATION AS AN APPLICABLE CORPORATION?

A. Once the determination has been made that the corporation is an Applicable Corporation, it must calculate tentative minimum tax and regular tax each year and pay the greater of the two. The Company's proposed calculation will be based only on current year AFSI for the Applicable Corporation (CenterPoint Houston in this case). Thus, the amount to be included in future requested revenue increases will reflect the stand-alone CenterPoint Houston jurisdictional calculations of CAMT. No amounts from other jurisdictional operations or costs of the parent company in the consolidated filing group will be included.

[2] I.R.C. § 59(k)(1)(D).

Q. IS THERE COMMISSION PRECEDENT FOR ALLOWING THE CAMT CREDIT CARRYFORWARD TO BE INCLUDED IN RATE BASE?

A. We are not aware of a Commission ruling with respect to a CAMT credit carryforward. However, the Commission has approved rate base inclusion of a nearly identical federal tax credit carryforward.

Q. PLEASE DESCRIBE THE COMMISSION ALLOWANCE OF PREPAID FEDERAL TAX CREDIT CARRYFORWARD.

A. In Docket No. 9850, the Commission allowed the Company to include in rate base the federal alternative minimum tax ("AMT") credit carryforward.[3]

Q. PLEASE DESCRIBE THE AMT CREDIT CARRYFORWARD.

A. Prior federal income tax law imposed the AMT at 20% of Alternative Minimum Taxable Income ("AMTI"). AMTI was a modified tax base adjusting for certain tax preference items. If the AMT was higher than the regular tax, a taxpayer paid the minimum tax. When the taxpayer paid the AMT, a credit carryforward (the AMT tax credit carryforward) was established, and a taxpayer could apply this credit in future years to offset the regular tax liability.

Q. HOW IS THE CAMT SIMILAR TO THE AMT?

A. The AMT and the CAMT are effectively the same taxing schemes. The AMT was imposed at 20% of a modified tax base (AMTI). The CAMT is imposed at 15% of a modified tax base (AFSI). Also like the AMT, which allowed a credit

[3] *Application of Houston Lighting & Power Co. for Authority to Change Rates*, Docket No. 9850, Order Granting Appeal of Examiners Ruling of January 31, 1991 (Feb. 20, 1991).

carryforward to apply against future regular tax liabilities, the CAMT allows a credit carryforward to apply against future regular tax liabilities.

Q. WHAT IS YOUR RECOMMENDATION REGARDING THE CAMT CREDIT CARRYFORWARD?

A. The CAMT credit carryforward is analogous to the AMT credit, which the Commission ruled was appropriate for the Company to include in rate base. Accordingly, we believe the Commission should permit the Company's CAMT credit carryforward to be included in rate base.

Q. WHAT ISSUES DOES STAFF WITNESS STARK HAVE WITH THE COMPANY'S PROPOSED RIDER IRA?

A. I would describe Ms. Stark's concerns as being primarily related to whether the CAMT recovery proposed comports with Public Utility Regulatory Act ("PURA") § 36.060. These concerns appear to be related to the following two areas:

- Whether the determination of the Company's status as an Applicable Corporation violates the stand-alone methodology; and
- Whether the Company's proposed calculation violates the stand-alone methodology.

Q. DESCRIBE MS. STARK'S TESTIMONY RELATING TO HER CONCERNS ABOUT TREATING THE COMPANY AS AN APPLICABLE CORPORATION FOR RATEMAKING PURPOSES AND WHETHER THAT COMPORTS WITH PURA § 36.060.

A. Ms. Stark recommends that the Company only be allowed to recover the CAMT it has requested if it meets the test for Applicable Corporation status, without regard to other members of the group. The requirement for meeting this test is whether the corporation's AFSI meets the $1 billion threshold (3-year average). Ms. Stark questions whether PURA § 36.060 requires that this test be calculated based solely on the expenses and income from CenterPoint Houston.

Q. DO YOU BELIEVE THE STAND-ALONE TEST IS REQUIRED OR APPROPRIATE TO DETERMINE WHETHER CAMT PAYMENTS SHOULD BE RECOVERED?

A. No. The enactment of the IRA and the resulting CAMT is a law that subjected every member of the single-employer group to CAMT. The Company has no ability to elect out of this law. It is much different than the consolidated tax savings adjustment (CTSA) provisions and discussions that Ms. Stark cites from prior dockets. Decisions about filing a consolidated return are made by election, unlike the mandatory CAMT. In this way, the Company has control over the outcome. In the case of CAMT, there is nothing a taxpayer can do to remove the requirement and no election it can make to lessen the impact. While the test to determine whether a corporation is an Applicable Corporation looks to the combined group AFSI, the law states that if the Parent of this group is an Applicable Corporation, so are all members of the group. CenterPoint Houston is one such member. As a result of this law, CenterPoint Houston is now an Applicable Corporation, and all members of the group will have a CAMT liability. While no single member of the combined group currently exceeds the $1 billion threshold alone, all members are subject to the tax by law because of CNP's status as the Applicable Corporation. To not allow the Company to recover its share of that tax, which the Company proposes to calculate on a stand-alone basis, would be inconsistent with well-established ratemaking practices regarding the recovery of income tax and would unfairly burden shareholders.

Q. DESCRIBE MS. STARK'S TESTIMONY RELATING TO HER CONCERNS ABOUT THE COMPANY'S PROPOSED CALCULATION OF CAMT AND WHETHER THAT COMPORTS WITH PURA § 36.060.

A. First, and important to note with regard to both of Ms. Stark's concerns, PURA § 36.060 dictates the computation of tax expense to reduce the rates. The CAMT does not impact total tax expense. Instead, it impacts the timing of cash payments.

In the Company's response to a discovery request, attached as Exhibit JKS-R-1, the proposed method for calculating CenterPoint Houston's CAMT liability was described. The following steps were outlined:

1. Confirm CNP consolidated (i.e. all members of a single employer) CAMT is in excess of regular tax.
2. Calculate CenterPoint Houston's contribution to AFSI on a stand-alone basis. CenterPoint Houston's AFSI is calculated by adjusting CenterPoint Houston's applicable financial statement income by adjustments to depreciation, pension costs and federal income tax to arrive at AFSI.
3. Compare CenterPoint Houston's CAMT stand-alone amount with CenterPoint Houston's regular stand-alone tax liability. If the stand alone CAMT is in excess of the stand-alone regular tax, the CAMT is recorded to CenterPoint Houston.
4. Functionalize CenterPoint Houston's recorded amount to transmission and distribution based on allocation factor total revenue requirement (TOTREV) approved in this proceeding.

Ms. Stark has expressed concern about the first step of the Company's proposed methodology for determining the correct amount of CAMT applicable. The first step as outlined looks to the combined group to determine whether CAMT is due to the Internal Revenue Service ("IRS") or not. Ms. Stark concludes in her testimony that the income and expenses of the Company's affiliates will determine how much CAMT the Company will pay.[4] She cites the Company's proposed methodology for determining the correct amount of CAMT resulting from CenterPoint Houston operations as support for her conclusion. She has included in bold on page 18 of her direct testimony that the Company proposed process includes "first confirming that CNP's consolidated CAMT is in excess of regular tax."[5] She then states that "[b]ased on the method CNP intends to use to calculate and allocate CAMT to its subsidiaries outlined above, it is not clear that the income tax consequences of the income, gains, losses and deductions of its affiliates would not be affecting the cost of service and rates CenterPoint Houston would charge its ratepayers for its services under this proposal."[6]

Q. DO YOU AGREE WITH MR. KOLLEN'S AND MS. STARK'S SUGGESTION THAT THE CALCULATION DOES NOT COMPORT WITH PURA § 36.060?

A. No.

Q. PLEASE EXPLAIN.

A. No affiliate revenues or expenses will be included in CenterPoint Houston's calculated CAMT amount. Steps 2-4 listed above make this clear. AFSI will be computed for the Company using only revenues and expenses related to jurisdictional operations. This amount is then multiplied by the minimum tax rate of 15% to determine CenterPoint Houston's CAMT liability.

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[4] Direct Testimony of Ruth Stark ("Stark Direct") at 18:18-21 (Jun. 26, 2024).

[5] *Id.* at 18:23-24 (emphasis omitted).

[6] *Id.* at 20:9-13.

The Company's proposal for step 1 of the calculation is solely for the benefit of customers. This step is meant to protect customers from paying for CAMT that will not ultimately be due to the IRS. What this means is that even if CenterPoint Houston had tentative minimum tax in excess of regular tax, if the single-employer group was not paying CAMT, the Company has proposed that CenterPoint Houston would not be responsible for the minimum tax liability it would otherwise have if it operated outside of the single-employer group. Instead, it would only be liable for the lower regular tax liability.

The Company made this proposal in order to ensure that customers only pay for minimum tax owed to the IRS. Finally, similar to my discussion of the NOLC in my direct testimony, the CAMT treatment requested by the Company is consistent with the "stand-alone" basis required by PURA § 36.060(a). ADIT associated with any CAMT will be adjusted on the Company's books when the tax payment is required. The Company's approach comports with PURA § 36.060(a) because only jurisdictional revenues and expenses are used to calculate CenterPoint Houston's portion of the CAMT. Furthermore, since CenterPoint Houston contributes to CNP being subject to the CAMT, it is appropriate under the stand-alone methodology to reflect its effect in rate base. It would be appropriate to reflect this effect in any proceeding where ADIT and rate base effected by a CAMT were presented to and reviewed by the Commission.

Q. WOULD THE SINGLE-EMPLOYER GROUP'S CAMT LIABILITY BE LESS IF CENTERPOINT HOUSTON'S OPERATIONS WERE NOT INCLUDED IN THE GROUP?

A. Yes. CenterPoint Houston significantly contributes to the overall CAMT liability. The payment to the IRS equals the AFSI of all member corporations, multiplied by the minimum tax rate of 15%.

Q. HOW MUCH, ON AVERAGE, DOES CENTERPOINT HOUSTON CONTRIBUTE TO THE GROUP'S PRE-TAX BOOK INCOME ("PTBI")?

A. CenterPoint Houston's operations comprise a significant portion of the group's PTBI, which is a rough translation for AFSI. Depending on the year and specific projects, it is approximately 60% - 70% of the group's total.

Q. WHAT DOES MS. STARK PROPOSE IF THE COMMISSION DOES ALLOW THE PROPOSED RIDER IRA?

A. Ms. Stark proposes that the Company should be required to update all non-CAMT accumulated deferred federal income taxes ("ADFIT") balances in all interim rate proceedings during which the rider is in effect.[7]

Q. DO YOU AGREE WITH MS. STARK?

A. No, I do not agree. There is very little relation between the CAMT carryforward and other items of ADFIT. With the exception of depreciation and possibly a small amount of pension expense, CAMT is calculated utilizing book numbers. For example, if the Company takes a large repairs deduction for tax purposes, there is

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[7] *Id.* at 25:12-14.

no impact to the CAMT calculation. Therefore, no mismatch exists from updating CAMT alone.

As described in my direct testimony, as well as Company witness Jacqueline Richert's direct and rebuttal testimony, CAMT creates an additional cash flow and potential credit metrics issue. The Company is simply seeking to recover the cost of additional financing required.

Additionally, if Ms. Stark's proposal were adopted, there would be significant mismatch between items in rate base and ADFIT in rates. For example, updating all ADFIT would include updating amounts related to assets and liabilities on the books that had not been updated in rates since the rate case such as ADFIT associated with regulatory assets and liabilities.

Q. WHAT IS OPUC WITNESS COYLE'S RATIONALE FOR REJECTING THE COMPANY'S PROPOSED IRA RIDER AND TREATMENT OF CAMT?

A. Ms. Coyle bases her position on her understanding of why the CNP single employer group is subject to the CAMT, citing a 2023 Wall Street Journal article. She also cites a recent settlement agreement in Indiana as well as uncertainty resulting from the future issuance of final guidance by the U.S. Department of the Treasury and the IRS on the CAMT.

Q. WHAT IS MS. COYLE'S PROPOSAL REGARDING THE IRA RIDER AND TREATMENT OF CAMT?

A. Ms. Coyle proposes instead that the Company be required to track and defer any *benefits* related to renewable electricity production tax credits ("PTCs") and clean energy investment tax credits ("ITCs") to refund to customers in the future.

Q. WHAT OBSERVATION DO YOU HAVE OF MS. COYLE'S ASSESSMENT OF RIDER IRA AND CAMT?

A. Although it is not clear, Ms. Coyle appears to dispute whether the CAMT will apply to the Company in the future. I will address that issue below. As an initial point, however, Ms. Coyle appears to acknowledge that if the CAMT applies it ultimately impacts "the cash flow metrics of a company."[8]

Q. HOW DOES RIDER IRA ENSURE THAT ALL IMPACTS OF THE CAMT ARE TAKEN INTO ACCOUNT?

A. The Company's proposed Rider IRA allows the Company to specifically track the impacts of the IRA and it will ensure that all of the impacts are captured on an annual basis. Other mechanisms available do not accomplish that all impacts are captured as efficiently. For example, the Distribution Cost Recovery Factor ("DCRF") and Transmission Cost of Service ("TCOS") interim rate mechanisms are not designed to address all impacts of the IRA. Those proceedings: (1) can only address the impact of the IRA as it relates to the certain plant accounts that are recovered through those mechanisms, (2) have no true-up mechanisms, and (3) have existing statutory timelines. The proposed Rider IRA would establish a more

[8] Direct Testimony – Errata 1 of Kyra Coyle at 34:15-17.

comprehensive, accurate, and discrete review of any impacts from the IRA. Ms. Coyle's recommendation implicitly acknowledges that the effects of IRA are not captured by existing mechanisms by recommending rejection of the rider on the one hand, yet imposing an obligation that the Company should be required to track and defer only the *benefits* of any tax credits to refund customers at some undetermined time in the future.

Q. DO YOU AGREE WITH MS. COYLE'S PROPOSALS?

A. No, I do not. As previously described in my testimony, CenterPoint Houston is an Applicable Corporation and that is a matter of law. Only CenterPoint Houston jurisdictional amounts, resulting from CenterPoint Houston operations, will be included in the Company's proposed calculation of CAMT. To suggest that the Company be required to track and defer tax *benefits* relating to the IRA (PTCs and ITCs) while simultaneously proposing to disallow real costs the Company will incur from the CAMT is asymmetrical and her proposal should be rejected. Furthermore, the fact that there is outstanding guidance from the U.S. Department of the Treasury and the IRS is the very reason why including costs and benefits associated with the IRA in the Rider IRA is appropriate. As new guidance is issued, amounts can be trued-up and customer rates will reflect the most recent guidance, rather than waiting to reflect these changes in customer rates in the Company's next rate case.

Q. WHAT IS YOUR RESPONSE TO MS. COYLE'S TESTIMONY ABOUT THE RECENT SETTLEMENT AGREEMENT REACHED IN INDIANA?[9]

A. Ms. Coyle's reliance on the Indiana settlement agreement[10] is misplaced. Ms. Coyle ignores the more relevant recent Unanimous Settlement Agreement reached in Texas at the Railroad Commission reflecting the impact of the IRA and CAMT as it will apply to all of CenterPoint Energy Resources Corp.'s ("CERC") Texas natural gas distribution operations.[11] In the Texas Unanimous Settlement Agreement, CERC and the other parties to the proceeding (one of which offered testimony from Mr. Kollen on the subject) agreed to establish a rider that will track the CAMT costs in the exact same manner that CenterPoint Houston has proposed in this filing.

Furthermore, Ms. Coyle also ignores important facts that distinguish the Indiana settlement from this proceeding. First, the CAMT was already included in the Indiana test period amounts, a distinction from this case and CERC's case I mentioned above. Second, as Ms. Coyle testified, CenterPoint Energy Indiana

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[9] *Id.* at 37:5-7.

[10] *Verified Petition Of Southern Indiana Gas And Electric Company d/b/a CenterPoint Energy Indiana South ("CEI South") For (1) Authority To Modify Its Rates And Charges For Electric Utility Service Through A Phase-In Of Rates, (2) Approval Of New Schedules Of Rates And Charges, And New And Revised Riders, Including But Not Limited To A New Tax Adjustment Rider And A New Green Power Rider (3) Approval Of A Critical Peak Pricing ("CPP") Pilot Program, (4) Approval Of Revised Depreciation Rates Applicable To Electric And Common Plant In Service, (5) Approval Of Necessary And Appropriate Accounting Relief, Including Authority To Capitalize As Rate Base All Cloud Computing Costs And Defer To A Regulatory Asset Amounts Not Already Included In Base Rates That Are Incurred For Third-Party Cloud Computing Arrangements, And (6) Approval Of An Alternative Regulatory Plan Granting CEI South A Waiver From 170 IAC 4-1-16(F) To Allow For Remote Disconnection For Non-Payment*, Cause No. 45990, Stipulation and Settlement Agreement (May 20, 2024).

[11] *Statement of Intent of CenterPoint Energy Resources Corp., d/b/a CenterPoint Energy Entex and CenterPoint Energy Texas Gas to Change Rates in the Unincorporated Areas and Municipalities that Have Ceded Original Jurisdiction with the Houston, Texas Coast, Beaumont/East Texas, and South Texas Divisions*, Docket No. OS-23-00015513 consol., Unanimous Settlement Agreement at para. 19 (Apr 23, 2024).

South has not abandoned its proposal regarding the tax rider, but simply deferred consideration of the issue to another, future docket. Finally, as with all settlement agreements, many factors were taken into account in arriving at the Indiana black-box settlement.

Q. PLEASE DESCRIBE MR. KOLLEN AND MR. POLLOCK'S TESTIMONY REGARDING SINGLE-ISSUE RATEMAKING.

A. Both Mr. Kollen and Mr. Pollock argue that Rider IRA amounts to single-issue or "piecemeal" ratemaking.

Q. WHAT IS YOUR RESPONSE TO THE SINGLE-ISSUE RATEMAKING ARGUMENT?

A. The Company's proposed Rider IRA is not unique—especially, in the context of issues related to tax. This Commission and many other commissions have recognized the need to make timely changes to customer rates resulting from income tax rate changes and changes in income tax law. These changes often occur outside of general rate cases. A recent and relevant example is when the Tax Cuts and Jobs Act ("TCJA") was signed into law on December 22, 2017. This Commission very quickly initiated proceedings to address the change in tax rate from 35% to 21%.[12]

On January 25, 2018, an accounting order was issued in that proceeding requiring CenterPoint Houston to establish a regulatory liability and track the difference between revenues collected at existing tax rates and revenues which

[12] *Proceeding to Investigate and Address the Effects of Tax Cuts and Jobs Act of 2017 on the Rates of Texas Investor-Owned Utility Companies*, Project No. 47945, Order Related to Changes in Federal Income Tax Rates (Jan. 25, 2018).

would have been collected at the new 21% rate.[13] The Commission directed that the regulatory liability should also include the amount of the decrease in ADIT between the current balance and what the balance would be at the new 21% rate. CenterPoint Houston immediately began refunding the regulatory liability to customers through the DCRF and TCOS mechanisms.[14] Subsequently, the Commission ordered the remaining refund of such over collected taxes in rates.[15]

Q. WHAT CONCLUSION DO YOU DRAW FROM THIS EXAMPLE?

A. The TCJA example underscores the need to address the impacts of tax rate changes and changes in tax law expeditiously. All stakeholders benefit from prompt quantification of the tax effects that are translated into rates quickly once the utility becomes subject to a new tax or a change in rate. This is because tax law changes (such as the TCJA and CAMT) can have major and often immediate implications for customers or the utility. Waiting to address those changes or implications in a full base rate proceeding is often not the best choice for customers or the utility. Inclusion of the CAMT DTA will allow the Company's overall cost of service to remain reasonable by permitting the Company to recover the time value of money on the cash that it will be required to pay and mitigate the risk the cash flow implications this tax may cause.

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[13] Project No. 47945, Order Related to Changes in Federal Income Tax Rates (Jan. 25, 2018); *id.*, Amended Accounting Order (Feb. 15, 2018).

[14] *Application of CenterPoint Energy Houston Electric, LLC to Revise its Wholesale Transmission Rates*, Docket No. 48065, Final Order (Apr. 27, 2018); *Application of CenterPoint Energy Houston Electric, LLC to Amend its Distribution Cost Recovery Factor*, Docket No. 48226, Final Order at Finding of Fact ("FoF") No. 33 (Aug. 30, 2018).

[15] *Application of CenterPoint Energy Houston Electric, LLC for Authority to Change Rates*, Docket No. 49421, Order at Ordering Paragraph No. 19 (Mar. 9, 2020).

Q. ARE YOU AWARE OF OTHER COMMISSIONS THAT HAVE ALLOWED THE CAMT DTA TO BE INCLUDED IN RATE BASE OR RECOVERED THROUGH A SEPARATE MECHANISM?

A. Yes. The Railroad Commission recently approved a Settlement Agreement that included a mechanism similar to the IRA Rider proposed in this case. The Railroad Commission specifically found that the IRA Rider proposed in that case was reasonable. The calculation of that rider mechanism is very similar to the mechanism proposed by the Company.[16] In Indiana, a CAMT DTA was included in cost-free capital as part of a recent settlement agreement to be considered by parties on September 3, 2024.[17]

Additionally, the Company is aware that other commissions, including the Illinois Commerce Commission have also determined that the CAMT DTA is appropriately included in rate base. In a recent rate proceeding in Illinois, the commission approved the inclusion of CAMT DTA in the cost of capital because the CAMT " . . . has the effect of reducing the tax benefits associated with accelerated tax deductions . . . " and that the DTA associated with the CAMT credit carryforward should be included in rate base.[18]

Finally, as Commission Staff witness, Ms. Ruth Stark points out in her direct testimony:

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[16] Docket No. OS-23-00015513 consol., Final Order at FoF No. 53 (Jun 26, 2024) ("The terms of the Rider Tax Act 2022 are reasonable.").

[17] Cause No. 45990, Stipulation and Settlement Agreement at 16.

[18] *Verified Petition for Approval of a Multi-Year Rate Plan under Section 16-108.18 of the Public Utilities Act*, Docket 23-0055, Order at 343-344 (Dec. 14, 2023).

> the Commission has in the past used the deferred accounting mechanism in the form of a regulatory liability to capture changes in federal income tax laws between rate cases that reduced utility taxes to the benefit of ratepayers. It is therefore not unreasonable in this case to capture the impacts of the change in the tax law between rate cases that could potentially increase income taxes, given that the tax law change is recent and its impact on CenterPoint Houston is uncertain.[19]

Q. PLEASE EXPLAIN YOUR UNDERSTANDING OF MR. KOLLEN'S OBJECTIONS WITH THE CALCULATION OF THE CAMT RIDER.

A. Although Mr. Kollen's objections to the Company's proposed CAMT rider lack specificity, Mr. Kollen appears to suggest that the Company has not provided sufficient details regarding the calculation of the amount to be included in the rider and the mechanics of the rider.[20]

Q. DO YOU AGREE THE COMPANY HAS NOT OFFERED SUFFICIENT DETAILS REGARDING THE CALCULATION OF THE AMOUNT TO BE INCLUDED IN THE RIDER IRA?

A. No. In my direct testimony and in response to discovery, I have provided a detailed explanation for the calculation of the Company's CAMT liability. I have summarized those calculations again in this rebuttal testimony.

Q. HAS THE COMPANY PROVIDED A SPECIFIC DESCRIPTION OF THE MECHANICS OF THE RIDER IRA?

A. Yes. Ms. Colvin describes the revenue requirement calculation of the Rider IRA. Mr. Durland describes the mechanics and timing for the CAMT tariff in his rebuttal testimony.

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[19] Stark Direct at 22:12-18.

[20] Direct Testimony of Lane Kollen ("Kollen Direct") at 71:5-72:2 (Jun. 19, 2024).

Q. WHAT DETAILS CAN YOU PROVIDE ABOUT THE PROPOSED RIDER IRA?

A. While Mr. Durland provides information about the tariff, I will explain the calculation of the CAMT that the Company is proposing. The Company proposes to make a filing each year in August, using the estimated December 31st balance of the CAMT carryforward for the same year end. The proposed calculation compares the balance of the CAMT credit carryforward in rates to the estimated balance of the CAMT credit carryforward for the year of the Rider IRA filing. The change in balance, multiplied by the Company's weighted average cost of capital approved in this proceeding, would then be included as either an increment or a decrement to rates via the rider. When the following year filing is made, it will include a true-up to the previous year amount in addition to a current year CAMT carryforward estimated amount.

Q. PLEASE DESCRIBE MR. KOLLEN'S ALTERNATIVE PROPOSAL TO THE RIDER IRA PROPOSED BY THE COMPANY.

A. Mr. Kollen testifies that if the Commission should authorize a new Rider IRA, it should be modified to include additional information in the tariff itself, as addressed by Mr. Durland. In addition, Mr. Kollen proposes that the return on the decrement of the ADIT NOLC should also be included in the rider. He also proposes to include the benefits associated with tax credits taken pursuant to the IRA.

Q. DO YOU AGREE WITH MR. KOLLEN'S PROPOSAL?

A. I agree in part. As Mr. Kollen cites in testimony, the Company has already agreed that benefits from tax credits should also be included in the rider. Regarding the

ADIT NOLC, the Company is only able to recognize increments and decrements to the unprotected NOLC in the rider. The consistency requirements of the normalization rules prohibit the protected portion from being included in a rider that does not also include associated tax expense, depreciation expense and ADIT.[21] Therefore, the Company would be open to including the unprotected NOLC activity in the Rider IRA. The Company would agree to include both the increments and decrements to the unprotected portion of the NOLC in the rider, not simply the decrements as Mr. Kollen has proposed.

B. EV Tax Credits

Q. WHAT DID GCCC WITNESS KOLLEN PROPOSE ON THE ISSUE OF ELECTRIC VEHICLE ("EV") CREDITS?

A. Mr. Kollen proposes that approximately $210,000 of EV and charging station credits that the Company intends to claim on its 2023 federal income tax return should be included to reduce the revenue requirement in this proceeding. His reasoning is that the Company earned these credits in the test year.

Q. DO YOU AGREE WITH MR. KOLLEN?

A. No. While I do agree with Mr. Kollen that the benefits from tax credits such as these should be passed on to customers, I do not agree that it is appropriate to include unknown amounts in the revenue requirement that will be recorded on the Company's books outside of the test period.

[21] Under the consistency rule, for ratemaking purposes a taxpayer must use the same estimate or procedure for its tax expense, depreciation expense and reserve for deferred taxes. *See* I.R.C. § 168(i)(9)(B).

Q. WHY WERE THESE AMOUNTS NOT RECORDED ON THE BOOKS IN THE TEST PERIOD?

A. When the Company estimates its taxes for the year (in this case, at December 31, 2023), it uses available information to derive tax expense for the year. When the Company files the federal income tax return the following year, full calculations are performed, and estimates made at year-end are trued-up on the financial statements to actuals filed on the tax return. At the time that the year-end provision for taxes was calculated, the tax department did not yet have information relating to the EV credits. Today, the amounts remain estimates because CNP's 2023 tax return has not been filed.

Q. WHEN DO YOU PROPOSE TO FLOW THE BENEFITS BACK TO CUSTOMERS FOR THESE EV CREDITS?

A. If the Company's Rider IRA is approved, the benefits for tax credits, including the EV credits Mr. Kollen discusses could be refunded through this rider.

IV. <u>ADIT AND EDIT</u>

A. Net Operating Losses

Q. PLEASE DESCRIBE HCC WITNESS HUNT'S ARGUMENTS TO EXCLUDE THE ADIT NOLC FROM RATE BASE.

A. Mr. Hunt explains in his testimony the two situations where he believes it is inappropriate to include the ADIT NOLC in rate base. First, he describes his belief that the only portion of the ADIT NOLC that should be allowed as a rate base item is the portion generated by costs included in the cost-of-service rate ***in this filing***. For the portion of the ADIT NOLC created by items not included in the cost-of-service rate, Mr. Hunt proposes that it be disallowed. The second situation

Mr. Hunt describes is when the consolidated NOLC is utilized on a federal tax return. He explains that the ADIT NOLC should no longer be included in rate base since the utilization of the NOLC to offset taxable income on the consolidated return has the effect of availing the associated cost-free capital to the Company.

Q. WHAT ARE MR. HUNT'S PROPOSALS?

A. Mr. Hunt proposes to remove:

- $33 million of ADIT NOLC from rate base, associated with 2021 and 2022 NOLCs.
- $42.4 million of 2023 ADIT NOLC from rate base, of which:
  - $17.75 million (which he describes as attributable to income tax items that are excluded from the requested revenue requirement) is a permanent removal; and
  - $24.64 million is deferred and included in CenterPoint Houston's next DCRF filing. Note that Mr. Hunt uses the amount here from the Company's initial filing in rate filing package ("RFP") workpaper WP/II-E-3.15. The revised amount of $24,737,563 was provided in the Company's errata filing on June 14, 2024.

The Company's NOLC filed in the errata RFP Schedules versus proposed adjustments from Mr. Hunt are summarized in the following table:

Summary NOLC (million $)
Company Filed and Hunt Proposal

	2021	2022	2023	Total / Cumulative
As Filed:				
Protected NOLC	$ 0.67	$ 12.51	$ 19.06	$ 32.24
Unprotected NOLC	$ 15.80	$ 4.06	$ 23.33	$ 43.19
Total NOLC	$ 16.47	$ 16.57	$ 42.39	$ 75.43
Hunt Proposals:				
Disallow - Utilized in CNP Consolidated Return	$ (16.47)	$ (16.57)		$ (33.04)
Disallow - Not in Cost of Service Rates			$ (17.75)	$ (17.75)
Defer to DCRF Filing			$ (24.60)	$ (24.60)
Hunt's Proposed NOLC in this Proceeding	$ -	$ -	$ -	$ -

Q. DO YOU AGREE WITH MR HUNT'S CONCLUSIONS AND PROPOSALS?

A. No. Mr. Hunt's conclusions are mistaken, errant in certain instances, and his resulting proposals should be denied.

Q. DO YOU AGREE WITH MR. HUNT'S PROPOSAL TO DISALLOW $33 MILLION RELATED TO 2021 AND 2022 NOLCS BECAUSE THE CONSOLIDATED GROUP WAS ABLE TO USE THESE AMOUNTS?

A. No. Mr. Hunt recommends that the NOLC ADIT be excluded from rate base because the NOLC has been included in an income tax return filed with the IRS to offset taxable income.[22] What is omitted from Mr. Hunt's testimony is the fact that CenterPoint Houston's NOLC was "used to reduce ***consolidated taxable income***" (emphasis added).[23] Using CNP consolidated income (i.e., income and expenses

[22] Direct Testimony of Steven D. Hunt ("Hunt Direct") at 11:6-24 (Jun. 19, 2024).

[23] *Id.* at 16:18.

of CNP and all its affiliates) to evaluate the Company's NOLC violates the stand-alone requirement of PURA § 36.060(a) because the use of CenterPoint Houston's NOLC relies on the income and deductions of all members of the CNP consolidated group (i.e., expenses and income items not included in the determination of the Company's revenue requirement).

Q. ARE THERE OTHER REASONS WHY YOU DISAGREE WITH MR. HUNT'S PROPOSAL TO DISALLOW PORTIONS OF THE ADIT NOLC THAT WERE USED TO OFFSET TAXABLE INCOME IN THE CONSOLIDATED TAX FILING?

A. Yes. Mr. Hunt's conclusion is based on his misunderstanding about the Company's accounting and policy related to net operating losses ("NOLs") within the consolidate tax filing group. It is possible Mr. Hunt's misunderstanding is due, in part, to a reference to a superseded tax allocation agreement inadvertently included in the Company's RFP schedules.

Q. PLEASE DESCRIBE THE OBSOLETE REFERENCE INADVERTENTLY INCLUDED IN THE COMPANY'S TESTIMONY.

A. In my direct testimony I refer to RFP Schedule II-E-3.4 as a detailed explanation of the accounting for inter-corporate tax allocations.[24] However, RFP Schedule II-E-3.4 actually describes a superseded inter-corporate tax allocation procedure, the Tax Sharing Agreement. The description of the procedure appears to provide that subsidiaries would be paid for current losses included in the consolidated return.[25]

[24] Story Direct at 1082:16-20 (bates stamp).

[25] CenterPoint Houston Application, Confidential RFP Schedule II-E-3.4, Line Nos. 12 -13 (Mar. 6, 2024).

This statement is incorrect and reflects a provision from a superseded Tax Sharing Agreement. In 2006, CNP and affiliates adopted the CNP Intercompany Tax Policy referenced on RFP Schedule II-E-3.4 and the provision described above was omitted.[26]

Q. PLEASE DESCRIBE THE RELEVANT ACCOUNTING TREATMENT, UNDER THE CURRENT CNP INTERCOMPANY TAX POLICY, FOR TAX NOLS GENERATED BY THE COMPANY AND UTILIZED BY THE CNP GROUP IN THE CONSOLIDATED RETURN.

A. The CNP Intercompany Tax Policy does not require that CNP compensate members, including the Company, for the use of NOLs by the consolidated group.[27]

Q. WAS THE COMPANY COMPENSATED FOR THE USE OF ITS NOL IN THE CNP CONSOLIDATED RETURN?

A. No. The Company has not been compensated for the NOL used by the parent and so it is necessary and appropriate to continue to include the balance of the ADIT NOLC in rate base. The Company has not realized the cost-free capital associated with the deferred tax liabilities ("DTLs") in rate base until the ADIT NOLC has been used by CenterPoint Houston or the Company has been compensated for the use of the NOL to offset taxable income from other members of the consolidated tax group. Since neither of these things have happened, Mr. Hunt's proposal should be denied.

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[26] The current CNP Intercompany Tax Policy was provided as a confidential attachment to RFP Schedule II-E-3.4. *See* CenterPoint Houston Application, Confidential RFP Schedule II-E-3.4, Line No. 20.

[27] CNP Intercompany Tax Policy, Exhibit B at 2, item #14 (Feb. 6, 2006).

Q. WHY IS THE COMPANY'S TREATMENT OF THE NOLC ADIT CONSISTENT WITH THE STAND-ALONE PRINCIPLE SET FORTH IN PURA § 36.060?

A. As I discussed in my direct testimony, the NOLC was determined for ratemaking purposes based on the revenues and operating expenses of the Company based on normalization principles for all temporary differences.[28] This treatment is referred to as the "stand-alone" basis. The ADIT NOLC will be adjusted when applied to reduce the Company's stand-alone taxable income. The Company's approach comports with PURA § 36.060(a) because only jurisdictional revenues and expenses are used to increase and reduce the NOLC. Furthermore, since the Company has received no payment for use of its NOLC in the consolidated return, it is appropriate under the stand-alone methodology to include this DTA in rate base until the Company is able to utilize it in the future to offset its taxable income.

Q. PLEASE DESCRIBE THE CNP INTERCOMPANY TAX POLICY AS IT RELATES TO NOLS.

A. As previously explained, the Company terminated its Tax Sharing Agreement and reinstated the CNP Intercompany Tax Policy in February 2006. This Intercompany Tax Policy allows for flexibility, to reflect the application of stand-alone accounting as required in various jurisdictions, in terms of how subsidiary NOLs are treated in the consolidated tax group. The starting point for all computations is a separate return basis. Because PURA § 36.060 mandates reporting at a stand-alone basis, the Company accounts for the Company's taxes in this manner. NOLs are recorded

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[28] Story Direct at 1080:6-15 (bates stamp).

to the Company when a stand-alone loss is generated. When these losses are utilized on the consolidated return, the parent (CNP) must either (1) pay CenterPoint Houston for the loss utilized; or (2) record a liability to offset the NOL DTA recorded at CenterPoint Houston until such time as CenterPoint Houston utilizes the DTA by reducing its own taxable income in the future.

Q. DO YOU AGREE WITH MR. HUNT'S PROPOSAL TO DISALLOW $17.75 MILLION OF THE 2023 NOLC ENTIRELY FROM RATE BASE?

A. No. Mr. Hunt's rationale for carving up the ADIT NOLC into amounts he believes are related and unrelated to cost-of-service revenues and expenses is flawed. His proposal would result in reductions to rate base in excess of cost-free-capital actually received by CenterPoint Houston.

Q. WHY DO YOU DISAGREE WITH MR. HUNT'S PROPOSAL TO DISALLOW PORTIONS OF THE ADIT NOLC HE DEEMS NOT RELATED TO COST OF SERVICE?

A. While Mr. Hunt acknowledges that a NOL is made up of many deductions, none of which can be considered the sole cause of the NOL,[29] his proposal to bifurcate the ADIT NOLC into portions related to certain deductions directly contradicts this statement. His stated purpose is to determine which portion of the 2023 NOL he believes relates to cost-of-service items. The Company's NOL in a given year is the result of operations (book income and expenses), along with tax adjustments, which both increase taxable income and decrease taxable income. As Mr. Hunt pointed out, it is not possible to attribute the NOL to specific deductions.

[29] Hunt Direct at 7:2-3.

In addition, Mr. Hunt is failing to acknowledge that a significant portion of the ADIT NOLC he is attempting to disqualify relates to items that are in cost-of-service rates in other regulatory filings the Company makes. He is selectively choosing, without any basis, specific deductions that he subjectively believes contribute to the ADIT NOLC and proposes to reduce the balance to be included in rate base. His rationale for doing so is flawed and his calculations are inconsistent with his stated position.

Q. PLEASE GIVE AN EXAMPLE OF AN ITEM MR. HUNT HAS PROPOSED TO REDUCE THE ADIT NOLC FOR.

A. One of the largest items in the Company's 2023 ADIT balance is related to temporary emergency electric energy facilities ("TEEEF"). The ADIT related to the TEEEF is included in rate base in a separate rate mechanism. That filing does not include an adjustment for ADIT NOLC. Therefore, the item is in cost of service, despite Mr. Hunt's claim that it is not. Even if the Company agreed with Mr. Hunt that the NOLC should be attributed to specific tax deductions, *which it does not*, Mr. Hunt has contradicted his own position by proposing to disallow the ADIT NOLC that he believes is related to the 2023 deduction for TEEEF.

Q. WHAT IS THE COMPANY'S POSITION WITH RESPECT TO ADIT NOLC BALANCES GENERATED BY COSTS RECOVERED IN OTHER COMMISSION PROCEEDINGS?

A. The Company believes it is prudent and far more reasonable to include the component of the ADIT NOLC generated by amounts subject to different recovery mechanisms in this proceeding. The inclusion of the entire eligible ADIT NOLC in this proceeding allows all parties to consider and track the NOLC balance holistically in a single proceeding. The Company has consistently maintained this approach because we believe it is sound, transparent ratemaking policy. Mr. Hunt's proposal to effectively balkanize the ADIT NOLC should be rejected.

Q. DO YOU AGREE WITH MR. HUNT'S PROPOSAL TO DEFER $24.4 MILLION OF THE 2023 ADIT NOLC TO BE INCLUDED IN THE DCRF FILING?

A. No, I do not. Mr. Hunt's rationale is that the amount is uncertain since the 2023 federal income tax return has not yet been filed. The test period for this proceeding is December 31, 2023. Therefore, the ADIT amounts included in this filing related to 2023 represent amounts recorded on the Company's books and records as of December 31, 2023. To suggest that only a DTA should be removed and not all of the DTLs that contributed to the generation of this DTA is selectively choosing, without any basis, and inappropriate. All amounts relating to 2023, tax deductions (DTLs) and adjustments to increase taxable income and tax carryforwards (DTAs), are subject to true-up when the Company's tax return is filed. Mr. Hunt has suggested that only one item, the ADIT NOLC DTA, should be excluded from rate base and deferred due to uncertainty. There are many large DTLs that were estimated for the 2023 tax return that would also need to be removed from rate base and deferred if this proposal were to be accepted. Mr. Hunt's proposal should be denied.

Q. DOES MR. HUNT ARGUE THAT THE NOLC ADIT WAS IMPRUDENTLY INCURRED?

A. No. It is important to note that the NOLC resulted from implementing complex tax planning strategies intended to provide tax benefits to customers, specifically, new tax accounting method elections (i.e., enhanced tax deductibility of certain indirect overhead costs). The implementation of these strategies generated significant up front tax deductions, resulting in a temporary stand-alone NOLC. However, these tax strategies will continue to generate accelerated tax deductions and benefit customers for many years into the future. The NOLC ADIT should be included in rate base thus encouraging the Company to continue to minimize the tax component.

Q. HOW IS MR. HUNT'S PROPOSAL QUANTITATIVELY FLAWED?

A. Mr. Hunt proposes to adjust the Company's test year NOLC ADIT of $42.4 million by excluding $17.75 million of NOLC ADIT he deems are attributable to amounts excluded from the requested revenue requirement.[30] Mr. Hunt calculated the $17.75 million exclusion by comparing the Company's test period NOLC ADIT of $42.4 million and a theorical NOL ADIT calculated using requested revenues (i.e., revenues that the Company has not received, and the Commission has not approved).[31] There is no basis for using requested revenues to calculate a test year NOLC ADIT. Mr. Hunt's calculation should be disregarded.

[30] *Id.* at 17:13-18:2.

[31] Mr. Hunt's NOL calculation, derived from Schedule II-E-3.15, is based on requested revenues [Column (3), Line No. 1] of $3.77 billion and not test year revenues [Column (1), Line No. 1] of $3.51 billion.

Q. MR. HUNT ALSO PROPOSES THAT IF THE COMMISSION ACCEPTS HIS RECOMMENDATION AND A NORMALIZATION VIOLATION IS A CONCERN, THAT THE COMPANY SHOULD SEEK A PRIVATE LETTER RULING ("PLR"). DO YOU AGREE?

A. No. Many PLRs have been issued determining that excluding the protected portion of the ADIT NOLC will result in a normalization violation. It is clear that excluding it from rate base and deferring it to another filing would likewise result in a normalization violation. Similarly, Mr. Hunt's proposal to remove the 2021 and 2022 ADIT NOLC amounts would also result in normalization violations. This issue has been settled by the IRS and to request another PLR would be imprudent. I have attached as Exhibit JKS-R-2 seven PLRs that demonstrate the IRS's consistent rulings on this matter.

B. Excess Deferred Income Taxes

Q. WHAT DID THE COMPANY PROPOSE IN THIS CASE REGARDING AMORTIZATION OF UNPROTECTED EXCESS DEFERRED INCOME TAX ("EDIT")?

A. The Company has proposed to amortize the remaining net unprotected EDIT over five years in base rates. The Settlement Agreement in the Company's last rate case proceeding provided that the Unprotected EDIT be returned to customers over approximately thirty to thirty-six months through Rider UEDIT in Docket No. 49421.[32] Additionally, the Company has noted that certain amounts included in the overall EDIT balance must now be reclassed from protected to unprotected,

[32] Docket No. 49421, Final Order at FoF Nos. 91 and 95.

resulting in a net unprotected EDIT balance that is an asset.[33] Similar to its request in Docket No. 49421, the Company has proposed to recover the EDIT balance from customers over the same period as the Company's other regulatory assets, or five years.

Q. PLEASE SUMMARIZE MR. KOLLEN'S PROPOSAL FOR AMORTIZING THE UNPROTECTED EDIT BALANCE.

A. Mr. Kollen argues that the Company should not be allowed to recover its unprotected EDIT balance over five years, but instead should be required to recover the unprotected EDIT over the service lives of the underlying assets. He states that since the EDIT amounts are related to plant, it would be maintaining the status quo to recover the balance over the same life as protected EDIT amounts.

Q. DO YOU AGREE WITH MR. KOLLEN'S PROPOSAL?

A. No. The status quo is to amortize ***protected*** EDIT amounts over the lives of the underlying assets using the Average Rate Assumption Method ("ARAM").[34] The Commission ordered the Company to amortize ***unprotected*** EDIT over approximately three years in Docket No. 49421. Plant-related amounts have always been included in the unprotected EDIT balance. For example, EDIT associated with casualty losses, Allowance for Funds Used During Construction (AFUDC) debt, Contributions in Aid of Construction (CIAC) and repairs and maintenance were included in the unprotected balance in Docket No. 49421. Mr. Kollen's proposal is, in fact, an alteration of the status quo and would create a longer

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[33] Story Direct at 1072:12-1073:19 (bates page).

[34] *See id.* at 1069:3-1072:15 for a discussion on EDIT and ARAM.

recovery period for this particular balance of unprotected EDIT. Mr. Kollen proposes a different treatment for an unprotected EDIT asset balance than the Commission's approved treatment for unprotected EDIT liabilities—when liabilities have already been refunded to customers by the Company. The Company has already proposed an amortization period greater than the 3-year EDIT liability amortization period ordered in Docket No. 49421. Mr. Kollen's proposal should be denied.

V. TEXAS MARGIN TAX

Q. WHAT DOES MR KOLLEN PROPOSE TO ADJUST IN THE TEXAS MARGIN TAX CALCULATION?

A. Mr. Kollen proposes two adjustments to the Texas margin tax expense included in the test year. First, he proposes to disallow adjustments made to reflect the actual amounts of tax paid on the filed Texas margin tax returns. Second, Mr. Kollen recommends modifying the method used to calculate the Texas margin tax expense included in the test year estimate.

Q. DO YOU AGREE WITH MR. KOLLEN'S RECOMMENDATION TO DISALLOW THE ADJUSTMENTS TO THE TEXAS MARGIN TAX THAT REFLECTS ACTUAL AMOUNTS PAID ON FILED TAX RETURNS?

A. No. The adjustments to reflect the actual amount of tax paid on tax returns are prudent and necessary tax expenses associated with the test year.

Q. PLEASE EXPLAIN FURTHER WHY THE ADJUSTMENTS TO THE TEXAS MARGIN EXPENSE ARE APPROPRIATE TO INCLUDE AS A TEST YEAR EXPENSE?

A. The Company is included in the CNP combined Texas margin tax return. Like all large complex taxpayers, CNP and its affiliates estimate tax liability at year end based on the best available facts at the time. After the CNP's books are closed, it begins the process of preparing income tax returns (federal, state and local) including the Texas margin tax return. Preparing tax returns compliant with complex tax laws and regulations requires additional time and analysis and almost always results in variances between the year-end accruals and the actual filed returns. The resulting adjustments are referred to as "return to accrual" ("RTA") adjustments. These adjustments can only be made after tax returns are filed in a subsequent year. RTA adjustments are made each year by the Company based on filed tax returns and are a necessary and prudent expenditure for the test period.

Q. ARE THERE ANY OTHER PROBLEMS WITH MR. KOLLEN'S RECOMMENDATION TO DISALLOW THE TEXAS MARGIN TAX RETURN ADJUSTMENTS?

A. Yes. As previously explained, the process of finalizing the Texas margin tax liability for particular tax year always results in a RTA adjustment in a test period. The nature of the tax compliance process and the lag in due dates for tax filings necessarily results in an RTA being recorded in a year subsequent to the tax year creating the RTA. If the Company is not allowed to recover the RTA recorded in the test period, it will never have the opportunity to recover this reasonable cost of doing business. Equally important, an RTA may result in a refund of Texas margin tax and allowing the Company to reflect RTAs in the calculation of the Texas margin tax expense will ensure that customers recognize the benefit if a test period RTA happens to be a refund.

Q. PLEASE EXPLAIN HOW MR KOLLEN PROPOSES TO ADJUST THE TEXAS MARGIN TAX CALCULATION.

A. Mr. Kollen recommends the Texas margin tax expense should be calculated using a hypothetical cost of goods sold ("COGS") calculation because this results in a lower allocation of CNP's Texas margin tax to the Company. Mr. Kollen's method is "hypothetical" because it is different from the method CenterPoint Houston is required to use on its Texas margin tax return. Mr. Kollen recommends recomputing the Texas margin tax expense by substituting the method used in filing the tax return with an alternative method, discussed below.

Q. PLEASE EXPLAIN THE TEXAS MARGIN TAX RETURN ELECTION MR. KOLLEN PROPOSES TO ADJUST.

A. CNP and affiliates filed its Texas margin tax return electing to calculate the taxable margin using the COGS method. Briefly, Texas allows taxpayers to compute the taxable margin by reducing taxable receipts either by actual COGS ("COGS method") or reducing the taxable receipts by an amount equal to 30% of taxable receipts ("30% method"). CNP elected, on behalf of the affiliated group, to use the COGS method. The COGS election is made by the parent of the consolidated/combined group and is binding on all affiliates, including CenterPoint Houston.[35]

CNP and affiliates have consistently used the COGS method in filing its Texas margin tax return. Similarly, CenterPoint Houston has consistently used the COGS method in computing regulatory tax expense since it was approved by the Commission in 2011.[36]

Q. PLEASE DESCRIBE MR. KOLLEN'S HYPOTHETICAL TEXAS MARGIN TAX DEDUCTION.

A. Mr. Kollen recommends disregarding the binding election made by its parent company to use the COGS method and instead proposes to compute the Texas margin Tax using a hypothetical 30% method.

Q. WHAT SUPPORT DOES MR. KOLLEN OFFER FOR HIS RECOMMENDATION TO USE A HYPOTHETICAL TEXAS MARGIN TAX DEDUCTION?

A. Mr. Kollen posits that the CNP election in conjunction with the stand-alone tax calculation methodology results in a subsidy from the Company to other CNP affiliates. Mr. Kollen proposes a two-step calculation for determining the Texas margin tax deduction which effectively would recompute the Texas margin tax in this case using a hypothetical 30% method.

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[35] Tex. Tax Code §171.1014(d).

[36] *Application of CenterPoint Energy Houston Electric, LLC for Authority to Change Rates,* Docket No. 38339, Order on Rehearing at FoF No. 161-165 (Jun. 23, 2011).

Q. DO YOU AGREE WITH MR. KOLLEN'S PROPOSAL?

A. No. Mr. Kollen's proposal ignores the required methodology used by the Company to compute its Texas margin tax expense. CenterPoint Houston, as a member of the CNP combined group in Texas, is required to use the COGS method. The Company is also required to compute its regulatory tax expense using a stand-alone approach. The Company has complied with both these obligations in calculating the test year Texas margin tax expense.

Q. HAS THIS COMMISSION PREVIOUSLY APPROVED THE COMPANY'S TEXAS MARGIN TAX CALCULATION USING THE COGS METHOD?

A. Yes. In Docket No. 38339, this Commission approved the Company's Texas margin expense using the COGS method.[37] The Commission noted that Texas law requires 'all entities in the CenterPoint state group to use the same method to calculate their margin' and CenterPoint Houston used this method to determine its test year expense.[38] This method has been used by the Company consistently at least since Docket No. 38339. Mr. Kollen ignores this precedent in the context of the Texas margin tax expense.

VI. <u>MEDICARE PART D SUBSIDY</u>

Q. PLEASE BRIEFLY DESCRIBE THE MEDICARE PART D SUBSIDY.

A. As explained in my direct testimony,[39] Congress passed the Medicare Prescription Drug, Improvement and Modernization Act of 2003, which granted a subsidy that was actuarially equivalent to Medicare Part D coverage ("Medicare Part D

[37] *Id.* at FoF Nos. 163-165.

[38] *Id.* at FoF No. 163

[39] Story Direct at 1096:11-23 (bates stamp).

Subsidy") to companies. This subsidy was meant to encourage employers to offer prescription drug coverage to retired employees. The subsidy was neither taxable, nor did it reduce the deductibility of the drug benefits being paid by the Company.

Q. PLEASE DESCRIBE THE TREATMENT OF THIS SUBSIDY FOR ACCOUNTING AND RATEMAKING PURPOSES.

A. The Company's tax rate included in customer rates beginning in 2004 included a permanent tax benefit representing all Medicare Part D Subsidies that the Company expected to receive in all future years. The amounts for future receipts included in this rate were actuarially determined and the total permanent tax difference computed was $28.6 million. To restate, the reduction in the tax rate related to Medicare Part D Subsidies reflected the nontaxability of <u>every future subsidy</u> the Company expected to get, <u>in all future years</u>. No ADFIT was recorded because the estimated "subsidy receivable" amounts were non-taxable. A deferred income tax asset was established for the gross liability representing payments made to or on behalf of retirees, since these amounts would be deductible when paid.

Q. PLEASE BRIEFLY DESCRIBE HOW THE LEGISLATION PASSED IN 2010 IMPACTED THE TREATMENT OF MEDICARE PART D SUBSIDIES.

A. In 2010, legislation was passed (the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 or "Health Care Legislation") which rendered the Medicare Part D Subsidies taxable beginning on January 1, 2013. Stated another way, the Medicare Part D Subsidy previously subject to a 0% tax rate was now subject to a 35% tax rate.

Q. WHAT WAS THE ACCOUNTING AND RATEMAKING TREATMENT OF THE MEDICARE PART D SUBSIDY WHEN THE HEALTH CARE LEGISLATION WAS ENACTED?

A. As a result of the Health Care Legislation in 2010, the Medicare Part D Subsidies became taxable beginning January 1, 2013. Subsidies received from 2004 – 2012 remained nontaxable, but there was no longer a permanent tax item for subsidies to be received in 2013 and beyond. The portion of the permanent difference relating to subsidies to be received after January 1, 2013, became a temporary difference. In addition, because the Company believed that the financial impacts associated with flowing the benefit (which the Company now would not receive) for 2013 and future subsidies back to customers via the lower tax rate would be recoverable, a regulatory asset was established. The amount of this regulatory asset was $9.3 million and represented $17.2 million of the $28.6 million permanent adjustment described above, times the tax rate in effect and grossed up for tax. My Direct Testimony[40] explains how the $17.2 million was derived.

Q. WHEN DID CENTERPOINT HOUSTON RATES CHANGE TO REFLECT THE TAXABILITY OF MEDICARE PART D SUBSIDY?

A. The Company's rates did not change until April 2020. This was sixteen years after the rates had been implemented. Prior to 2020, customer rates reflected the law in 2004, which assumed that all subsidies received in all future years would be nontaxable. So, even though Medicare Part D Subsidies had been taxable since

[40] *Id.* at 1098:5-16 (bates stamp).

2013, customer rates continued to reflect the assumption that all years of subsidies received would be nontaxable (current, present and future).

Q. WHAT HAS THE COMPANY PROPOSED IN THIS FILING WITH REGARD TO THE MEDICARE PART D SUBSIDY REGULATORY ASSET?

A. The Company has proposed to recover the remaining $11 million regulatory asset over 5 years, consistent with the treatment of other assets and liabilities in this proceeding.

Q. WHAT HAS MR. KOLLEN PROPOSED?

A. Mr. Kollen has proposed to disallow all recovery of the regulatory asset in this proceeding.

Q. PLEASE DESCRIBE THE HISTORY OF PROCEEDINGS IN WHICH CENTERPOINT HOUSTON HAS REQUESTED RECOVERY OF A MEDICARE PART D SUBSIDY AMOUNT, INCLUDING AGREEMENT OR DISAGREEMENT WITH MR. KOLLEN'S TESTIMONY ABOUT THESE PROCEEDINGS.

A. The Company first requested recovery of a Medicare Part D regulatory asset in Docket No. 38339, where the administrative law judges ("ALJs") recommended recovery of the $9.3 million regulatory asset in rates over the Company's proposed three-year period.[41] The Proposal for Decision ("PFD") issued by the ALJs also recommended an increase to the tax rate to reflect the future taxability of Medicare Part D Subsidies. The Commission rejected the ALJ's recommendation in that

[41] Docket No. 38339, Proposal for Decision at 136 (Dec. 3, 2010).

docket, citing the 2013-effective date of the Health Care Legislation, two years after the date of the rates proceeding. However, in finding of fact 159A to the Final Order in Docket No. 38339, the Commission authorized the Company to continue to monitor and accrue the difference between what rates assume the Medicare subsidy tax expense would be and the actual amount the Company is required to pay as a regulatory asset to be addressed in the Company's next rate case.

Q. HOW DOES MR. KOLLEN'S TESTIMONY COMPARE TO THE HISTORICAL REALITY?

A. In general, Mr. Kollen's testimony concurs with this reality. Mr. Kollen, however, omits the term "continue" in his quote from the Final Order at Finding of Fact 159A.[42] That provision provided that the Company was allowed to continue "to monitor and accrue the difference" between what was in rates for the subsidy and what CenterPoint Houston would be required to pay.

Q. WHY IS THAT OMISSION SIGNIFICANT?

A. This omission is significant, as Mr. Kollen uses it to substantiate his position that the Company should not be allowed to recover the impacts of the rate reduction that represented future years subsidy collection for the period 2004-2009. It is clear to the Company that being allowed to continue to track these amounts does not demonstrate the Commission's agreement with Mr. Kollen's position.

[42] Kollen Direct at 33:16-18.

Q. WHAT FURTHER EVIDENCE IS THERE THAT THE COMMISSION INTENDED FOR CENTERPOINT HOUSTON TO CONTINUE TO MONITOR AND ACCRUE THE REGULATORY ASSET?

A. At the February 3, 2011, Commission open meeting, the commissioners engaged in a discussion with Mr. Jason Ryan (then serving as a legal representative of Company) on the Medicare Part D issue. In that discussion Mr. Ryan noted:

> One possibility would be – we have created a regulatory asset for the difference in what our rates assumed and the reality of what we will have to pay for ***prior years*** (emphasis added). So that reg asset is part of what the PFD addresses. One way to resolve this is to continue to accrue that difference in '10, '11 and '12 and deal with the recovery of that regulatory asset in the next rate case assuming that the Healthcare Act of 2010 is not repealed, and, in fact, there is a real change that occurs every year.[43]

In response, Chairman Smitherman said, "I think it is an elegant solution."[44] Simply put, the commissioners agreed with the Company that the regulatory asset would "continue to accrue that difference [in what our rates assumed and the reality of what we will have to pay for prior years] in '10, '11, and '12 and deal with the recovery of that regulatory asset in the next rate case assuming that the Healthcare Act of 2010 is not repealed . . . ."[45]

Q. WHAT WAS THE COMMISSION CONCERNED WITH REGARDING THE TIME PERIOD RELATED TO THE MEDICARE PART D SUBSIDY?

A. As the Commissioners stated at that Open Meeting, they recognized that the Company had to accrue the expense when recognized for periods that went back

[43] *See* Open Meeting Tr. at 154:19-155:4 (Feb. 3, 2011).

[44] *Id.* at 156:4-5.

[45] *Id.* at page 154:19-155:3.

until the effective date of the 2003 legislation. However, they were concerned that the 2010 legislation could be repealed before it went into effect in 2013; thereby, calling into question if it was actually known and measurable at that time in 2011.

Q. WHEN WAS THE ISSUE OF MEDICARE PART D SUBSIDY ADDRESSED AGAIN?

A. In Docket No. 49421, the Company again sought to recover the Medicare Part D Subsidy regulatory asset. Having followed the Commission's Order in Docket No. 38339, the accrued regulatory asset balance at December 31, 2018 was $33.2 million. A settlement agreement was reached in Docket No. 49421, whereby all regulatory assets were to be amortized over five years. The Medicare Part D Subsidy regulatory asset was never directly addressed in that settlement agreement. However, the Company complied with the settlement agreement's amortization period term as it related to the Medicare Part D Subsidy regulatory asset on the Company's books and records. Nevertheless, Mr. Kollen cites to a PFD received before the settlement agreement was reached as support for his continued assertion to improperly exclude portions of the subsidy recognized in the rate prior to 2013. In Docket No. 49421, Mr. Kollen initially opposed any recovery of the Medicare Part D regulatory asset alleging five errors in the computation. The ALJs found CenterPoint Houston's arguments persuasive on all but one of his alleged errors. Mr. Kollen fails to acknowledge that part of the PFD as he attempts to bring those same arguments into this proceeding.[46] Regardless, the settlement agreement in Docket No. 49421 allowed the Company to include the $33.2 million Medicare Part

[46] Kollen Direct at 36:5-8.

D regulatory asset it had requested to be amortized over 5 years. $24.5 million of this Medicare Part D regulatory asset has been amortized as of the end of the test period in this proceeding. Mr. Kollen's reliance on a PFD's findings that were not reflected in the final settlement agreement in Docket No. 49421 is inappropriate and should be ignored.

Q. PLEASE PLACE THE CURRENT PROCEEDING IN CONTEXT WITH THE HISTORY YOU OUTLINED ABOVE.

A. In the current proceeding, the Company has included the remaining unamortized balance of the Medicare Part D regulatory asset and is seeking to recover that balance in this case. This balance includes a $2.3 million accrual for the period between the end of the test period in Docket No. 49421 and when rates were implemented in April of 2020. After reducing the balance for $24.5 million in amortization, the balance in the current proceeding is $11 million.

Q. HOW DO YOU RESPOND TO MR. KOLLEN'S ASSERTION THAT THE COMPANY'S REQUEST IS INCONSISTENT WITH COMMISSION PRECEDENT?

A. I disagree with Mr. Kollen for the reasons cited above. CenterPoint Houston has proposed to recover the remaining $11 million regulatory asset over 5 years, consistent with the treatment of other assets and liabilities in this proceeding. The table in my Direct Testimony[47] explains how the $11 million was derived.

[47] Story Direct at 1104 at 9-11 (Table) (bates stamp).

Q. AS AN ALTERNATIVE TO THE COMPANY'S REGULATORY ASSET RELATED TO THE MEDICARE PART D SUBSIDY, WHAT DOES MR. KOLLEN PROPOSE AS A POST-TEST YEAR ADJUSTMENT?

A. As an alternative to his denial that a regulatory asset related to the Medicare Part D Subsidy exists, Mr. Kollen recommends a post-test year adjustment to amortize the balance of the regulatory asset through December 31, 2024, or to a zero balance that he claims would exist at that time. First, Mr. Kollen is incorrect that, if the Company recorded additional amortization of the Medicare Part D Subsidy regulatory asset through the end of December 2024, the balance would be zero. The amortization period related to Docket No. 49421 ends in April 2025, well after the test year end presented in this case. In addition, the balance of the regulatory asset in this filing includes not only the unamortized balance included in Docket No. 49421, but subsequent charges that occurred from January 2019 through April 2020, and are being requested for the first time.

Q. WHAT DO YOU RECOMMEND?

A. I recommend that the Company be allowed to recover the remaining $11 million Medicare Part D regulatory asset. This is consistent with precedent in the last two dockets. The Company is simply proposing to recover benefits that were flowed to customers that the Company never received.

VII. ATTENDANT IMPACTS OF DISALLOWED RATE BASE ITEMS

Q. ARE COMMISSION STAFF AND INTERVENOR WITNESSES PROPOSING ADJUSTMENTS TO CENTERPOINT HOUSTON'S RATE BASE?

A. Yes, multiple witnesses are proposing adjustments to CenterPoint Houston's capital. Company witnesses Randal M. Pryor, David Mercado, Eric D. Easton, and Mandie Shook explain why these investments are prudent and should be allowed. To the extent that the Commission removes any of these investments or other rate base items from the Company's request I address below the attendant ADIT and EDIT impacts that must be considered.

Q. PLEASE EXPLAIN WHY ADIT AND EDIT MUST BE ADJUSTED IF CAPITAL OR OTHER RATE BASE ITEMS ARE ADJUSTED.

A. Any capital asset added since the last rate case that has a net *book* basis that is different than the net *tax* basis also has an associated ADIT balance. If that asset was added before 2018 the ADIT was initially established using the 35% federal income tax rate. With the enactment of the TCJA, that federal income tax rate was lowered to 21%. The resulting EDIT associated with those assets is included as a rate base component in this current proceeding. Therefore, both ADIT and EDIT must be considered when adjusting capital or any other rate base item with a net book basis that is different than net tax basis.

Q. DOES GCCC WITNESS MR. KOLLEN, FOR EXAMPLE, COMPUTE THESE ATTENDANT IMPACTS IN HIS TESTIMONY?

A. Yes. Mr. Kollen applies the statutory tax rate to his proposed disallowances. However, for his proposal to remove the carrying costs for the Hurricane Harvey regulatory asset, he assumed that the Company had no associated ADIT offset in rate base.[48] The Company has included a deferred tax liability associated with the regulatory asset for Hurricane Harvey for both the costs and the carrying charges of $2.1 million.[49] If the Commission agrees that Mr. Kollen's carrying costs for Hurricane Harvey are to be removed from rate base, then the associated ADIT DTL should be added back to rate base.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

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[48] *See* Kollen Direct at WP LK-1 (Revenue Requirement Adjustments Model) 'Hurr Harvey Carrying Charges', columns B-H, line 13.

[49] See CenterPoint Houston Application, RFP WP/II-E-3.5.1h T09S05, line 8 for the Hurricane Harvey regulatory asset DTL.

CENTERPOINT ENERGY HOUSTON ELECTRIC, LLC
PUC DOCKET NO. 56211
SOAH DOCKET NO. 473-24-13232

GULF COAST COALITION OF CITIES
REQUEST NO.: GCCC02-08

QUESTION:

Confirm that it is the intent of CNP to allocate the consolidated tax return CAMT to its affiliates. If confirmed, then describe the manner in which CNP intends to allocate the consolidated tax return CAMT to its affiliates and describe the manner in which the Company intends to allocate its allocation of the CNP consolidated tax return CAMT to function (distribution, transmission, etc.). Provide a copy of all analyses and/or other documentation developed by CNP or the Company that assesses, analyzes, or otherwise sets forth this multilevel allocation process.

ANSWER:

CNP intends to record the CAMT to the entities contributing to the CAMT using the process outlined below.

1. Confirm CNP consolidated (i.e., all members of a single employer) CAMT tax is in excess of regular tax.[1]
2. Calculate CEHE's contribution to AFSI on a stand-alone basis. CEHE's AFSI is calculated by adjusting CEHE's applicable financial statement income by adjustments to depreciation, pension costs and federal income tax to arrive at AFSI.[2]
3. Compare CEHE's CAMT stand-alone amount with CEHE's regular stand-alone tax liability. If the stand alone CAMT is in excess of the stand-alone regular tax, the CAMT is recorded to CEHE.
4. Functionalize CEHE's recorded amount to transmission and distribution based on allocation factor total revenue requirement (TOTREV) approved in this proceeding. [3]

[1] See Direct Testimony – Jennifer K. Story at Bates Stamp page 1050 and I.R.C. § 55(a).
[2] I.R.C. § 56A.
[3] See Direct Testimony – Kristie L. Colvin at Bates Stamp page 868.

SPONSOR:
Kristie Colvin/Jennifer Story

RESPONSIVE DOCUMENTS:

None

Other Agency Materials

UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201436037 (May. 22, 2014)

LTR 201436037, May 22, 2014

Symbol: CC:PSI:B06-PLR-148310-13

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated November 25, 2013, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A and State B. It is wholly owned by Parent. Taxpayer is engaged in the transmission, distribution, and supply of electricity in State A and State C. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer individually (as well as the consolidated return filed by Parent) has or expects to, produce a net operating loss (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" — that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "with or without" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission B on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission B policy and were not flowed thru to ratepayers. The data originally filed in Case included six months of forecast data, which the Taxpayer updated with actual data in the course of proceedings. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission B offset rate base by Taxpayer's ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission B was, if Commission B allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then Taxpayer's income tax expense element of service should be reduced by that same amount.

Commission B, in an order issued on Date C, allowed Taxpayer to reduce ADIT by the amount that Taxpayer calculates did not actually defer tax due to the presence of the NOLC and ordered Taxpayer to seek a ruling on the effects of an NOLC on ADIT. Rates went into effect on Date C.

Taxpayer proposed, and Commission B accepted, that it be permitted to annualize, rather than average, its reliability plant additions and to extend the period of anticipated reliability plant additions to be included in rate base for an additional quarter. Taxpayer also proposed, and Commission B accepted, that no additional ADIT be reflected as a result of these adjustments inasmuch as any additional book and tax depreciation produced by considering these assets would simply increase Taxpayer's NOLC and thus there would be no net impact on ADIT.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

In Case, Commission B has reduced rate base by Taxpayer's ADIT account, as modified by the account which Taxpayer has designed to calculate the effects of the NOLC. Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission B is in accord with the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the second issue, § 1.167(1)-(h)(6)(i) provides, as noted above, that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Increasing Taxpayer's ADIT account by an amount representing those taxes that would have been deferred absent the NOLC increases the ADIT reserve account (which will then reduce rate base) beyond the permissible amount.

Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6 (Passthroughs & Special Industries).

cc: *****

Other Agency Materials

UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201436038 (May. 22, 2014)

LTR 201436038, May 22, 2014

Symbol: CC:PSI:B06-PLR-148311-13

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated November 25, 2013, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A and State B. It is wholly owned, through a limited liability company, by Parent. Taxpayer is engaged in the transmission, distribution, and supply of electricity in State A and State C. Taxpayer also provides natural gas and natural gas transmission services in State A. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including “bonus depreciation” where available and, for each year beginning in Year A and ending in Year B, Taxpayer individually (as well as the consolidated return filed by Parent) has or expects to, produce a net operating loss (NOL). On its regulatory books of account, Taxpayer “normalizes” the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute “cost-free capital” to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries — a “deferred tax asset” and a “deferred tax expense” — that reflect that portion of those ‘tax losses’ which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a “with or without” methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission B on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission B policy and were not flowed thru to ratepayers. The data originally filed in Case was updated in the course of proceedings. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission B offset rate base by Taxpayer's ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT.

On Date C, a settlement agreement was filed with Commission B, incorporating the Taxpayer's proposed treatment of the tax consequences of its NOLC. In an order issued on Date D, Commission B issued an order approving the settlement agreement and also ordered Taxpayer to seek a ruling on the effects of an NOLC on ADIT. Rates went into effect on Date E.

Taxpayer proposed, and Commission B accepted, that it be permitted to annualize, rather than average, its reliability plant additions and to extend the period of anticipated reliability plant additions to be included in rate base for an additional eight months. Taxpayer also proposed, and Commission B accepted, that no additional ADIT be reflected as a result of these adjustments inasmuch as any additional book and tax depreciation produced by considering these assets would simply increase Taxpayer's NOLC and thus there would be no net impact on ADIT.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

In Case, Commission B has reduced rate base by Taxpayer's ADIT account, as modified by the account which Taxpayer has designed to calculate the effects of the NOLC. Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission B is in accord with the normalization requirements. The “with or without” methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of “flow through” of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the “with and without” method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the second issue, § 1.167(1)-(h)(6)(i) provides, as noted above, that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer’s rate of return is applied exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer’s expense in computing cost of service in such ratemaking. Increasing Taxpayer’s ADIT account by an amount representing those taxes that would have been deferred absent the NOLC increases the ADIT reserve account (which will then reduce rate base) beyond the permissible amount.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a “with or without” basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6 (Passthroughs & Special Industries).

cc: *****

Other Agency Materials

UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201438003 (Jun. 12, 2014)

LTR 201438003, June 12, 2014

Symbol: CC:PSI:B06-PLR-104157-14

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated January 24, 2014, and additional submission dated May 19, 2014, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated, investor-owned public utility incorporated under the laws of State A primarily engaged in the business of supplying electricity in State A. Taxpayer is subject to the regulatory jurisdiction of Commission A and Commission B with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis.

Taxpayer is wholly owned by Parent, and Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, calendar Year A. It then projected data for Year B through Year C. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to, and did, go into effect for the period Date B through Date C.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available in all years for which data was provided. Additionally, Taxpayer forecasted that it would incur a net operating loss (NOL) in Year D. Taxpayer anticipated that it had the capacity to carry back a portion of this NOL with the remainder producing a net operating loss carryover (NOLC) as of the end of Year D.

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries — a "deferred tax asset" and a "deferred tax expense" — that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced as of the end of Year D by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules Testimony by another participant in Case argued against Taxpayer's proposed calculation of ADIT.

Commission A, in an order issued on Date D, held that it is inappropriate to include the NOL in rate base for ratemaking purposes. Commission A further stated that it is the intent of the Commission that Taxpayer comply with the normalization method of accounting and tax normalization regulations. Commission noted that if Taxpayer later obtains a ruling from the IRS which affirms Taxpayer's position, Taxpayer may file seeking an adjustment. Commission A also held that to the extent tax normalization rules require recording the NOL to rate base in the specified years, no rate of return is authorized.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of

service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission A is not in accord with the normalization requirements.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would, in effect, flow the tax benefits of accelerated depreciation deductions through to rate payers. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6 (Passthroughs & Special Industries).

cc: *****

Other Agency Materials

UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201519021 (Feb. 04, 2015)

LTR 201519021, February 04, 2015

Symbol: CC:PSI:B06-PLR-136851-14

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated October 1, 2014, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated, investor-owned public utility incorporated under the laws of State A primarily engaged in the business of supplying natural gas service in State A. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and as to the rates it may charge for the provision of service. Taxpayer's rates are established on a cost of service basis.

Taxpayer is wholly owned by Parent, and Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, calendar Year A. It then projected data for Year B through Year D. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to, and did, go into effect for the period Date B through Date C.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available in all years for which data was provided. Additionally, Taxpayer forecasted that it would incur a net operating loss (NOL) in each of Year B, Year C, and Year D. Taxpayer anticipated that it had the capacity to carry back a portion of this NOL with the remainder producing a net operating loss carryover (NOLC) as of the end of Year C and Year D, the beginning and end of the test period.

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced as of the end of Year D by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules Testimony by another participant in Case argued against Taxpayer's proposed calculation of ADIT.

Commission, in an order issued on Date D, held that it is inappropriate to include the NOL in rate base for ratemaking purposes. Commission further stated that it is the intent of the Commission that Taxpayer comply with the normalization method of accounting and tax normalization regulations. Commission noted that if Taxpayer later obtains a ruling from the IRS which affirms Taxpayer's position, Taxpayer may file seeking an adjustment. Commission also held that to the extent tax normalization rules require including the NOL in rate base in the specified years, no rate of return is authorized.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of

service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission is not in accord with the normalization requirements.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would, in effect, flow the tax benefits of accelerated depreciation deductions through to rate payers. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6, Office of the Associate Chief Counsel (Passthroughs & Special Industries).

Wolters Kluwer CCH AnswerConnect

Other Agency Materials

UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201534001 (May. 13, 2015)

LTR 201534001, May 13, 2015

Symbol: CC:PSI:B06-PLR-103300-15

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated January 9, 2015, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is the common parent of an affiliated group of corporations and is incorporated under the laws of State A and State B. Taxpayer is engaged primarily in the businesses of regulated natural gas distribution, regulated natural gas transmission, and regulated natural gas storage. Taxpayer's regulated natural gas distribution business delivers gas to customers in several states, including State A. Taxpayer is subject to, as relevant for this ruling, the regulatory jurisdiction of Commission with respect to terms and conditions of service and as to the rates it may charge for the provision of its gas distribution service in State A. Taxpayer's rates are established on a "rate of return" basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer's application was based on a fully forecasted test period consisting of the twelve months ending on Date B. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. In a final order dated Date C, rates were approved by Commission for service rendered on or after Date D.

In each year from Year A to Year B, Taxpayer incurred a net operating loss carryforward (NOLC). In each of these years, Taxpayer claimed accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available. On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State C, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules. The attorney general for State C argued against Taxpayer's proposed calculation of ADIT.

Commission, in its final order, agreed with Taxpayer but concluded that the ambiguity in the relevant normalization regulations warranted an assessment of the issue by the IRS and this ruling request followed.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with (and, hence, violative of) the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, to reduce Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)- 1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "last dollars deducted" methodology employed by Taxpayer ensures that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "last dollars deducted" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6, Office of the Associate Chief Counsel (Passthroughs & Special Industries).

cc: *****

Other Agency Materials

UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201548017 (Aug. 19, 2015)

LTR 201548017, August 19, 2015

Symbol: CC:PSI:B06-PLR-116998-15

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated May 14, 2015, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is primarily engaged in the regulated distribution of natural gas in State A. It is incorporated in State B and is wholly owned by Parent. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer incurred net operating losses (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "last dollars deducted" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission policy and were not flowed thru to ratepayers. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission offsets rate base by Taxpayer's ADIT balance. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission was, if Commission allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then an offsetting reduction should be made to Taxpayer's income tax expense element of service.

A Utility Law Judge upheld Taxpayer's position with respect to the NOLC-related ADIT and ordered Taxpayer to seek a ruling from the Internal Revenue Service on this matter. This request is in response to that order.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the proposed order by the Utility Law Judge upholding Taxpayer's position that the NOLC-related deferred tax account must be included in the calculation of Taxpayer's ADIT is in accord with the normalization requirements. The “last dollars deducted” methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "last dollars deducted" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. In addition, such adjustment would be made specifically to mitigate the effect of the normalization rules in the calculation of Taxpayer's NOLC-related ADIT. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules. See generally, § 1.46-6(b)(2)(ii) (In determining whether, or to what extent, the investment tax credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service); Rev. Proc 88-12, 1988-1 C.B. 637, 638 (It is a violation of the normalization rules for taxpayers to adopt any accounting treatment that, directly or indirectly flows excess tax reserves to ratepayers prior to the time that the amounts in the vintage accounts reverse). This "offsetting reduction" would violate the normalization provisions.

Based on the representations submitted by Taxpayer, we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Peter C. Friedman, Senior Technician Reviewer, Branch 6, Office of Associate Chief Counsel (Passthroughs & Special Industries).

cc: *****

Other Agency Materials

UIL No. 0167.22-01 Depreciation; Public utility property; Normalization rules. IRS Letter Ruling 201709008 (Dec. 02, 2016)

LTR 201709008, December 02, 2016

Symbol: CC:PSI:B06-PLR-119381-16

Uniform Issue List No. 0167.22-01

[Code Sec. 167]

Depreciation; Public utility property; Normalization rules.

This letter responds to the request, dated June 15, 2016, submitted by Parent on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is an integrated electric utility headquartered in State. Taxpayer is a wholly owned subsidiary of Parent and is included in Parent's consolidated federal income tax return. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer's business includes retail electric utility operations regulated within State by Commission A and Taxpayer is subject to the regulatory jurisdiction of Commission B with respect to terms and conditions of its wholesale electric transmission service and as to the rates it may charge for the provision of such services. Taxpayer's rates are established on a cost of service basis.

On Date 1, Taxpayer filed a rate case application (Case) with Commission B requesting authorization to change from charging stated rates for wholesale electric transmission service to a formula rate mechanism pursuant to which rates for wholesale transmission service are calculated annually in accordance with an approved formula. The proposed formula consisted of updating cost of service components, including investment in plant and operating expenses, based on information contained in Taxpayer's annual financial report filed with Commission B, as well as including projected transmission capital projects to be placed into service in the following year. The projections included are subject to true-up in the following year's formula rate.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including “bonus depreciation” on its tax returns to the extent that such depreciation was available. Taxpayer incurred a net operating loss (NOL) in each of Year 1 through Year 2 due to Taxpayer's claiming bonus depreciation, producing a net operating loss carryover (NOLC).

On its regulatory books of account, Taxpayer “normalizes” the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute “cost-free capital” to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries – a “deferred tax asset” and a “deferred tax expense” – that reflect that portion of those ‘tax losses’ which, while due to accelerated depreciation, did not actually defer tax because of the existence of a NOLC.

In the setting of utility rates by Commission B, a utility's rate base is offset by its ADIT balance. In its rate case filing, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules.

On Date 2, Commission B issued an order accepting Taxpayer's revisions to its rates. On Date 3, new rates went into effect, subject to refund. Several intervenors submitted challenges to the rate case and on Date 4, Taxpayer and those intervenors entered into a Settlement Agreement, which was filed with Commission B. On Date 5, Commission B issued an order accepting the Settlement Agreement, which allows for the inclusion of the ADIT related to the NOLC asset in rate base.

Commission B further stated in the order that it is the intent of Commission B that Taxpayer comply with the normalization method of accounting and tax normalization regulations. The order also requires Taxpayer to seek a private letter ruling (PLR) from the Service regarding Taxpayer's treatment of the ADIT related to the NOLC asset. Commission B also noted that after the Service issues a PLR, Taxpayer shall adjust, to the extent necessary, its ratemaking treatment of the ADIT related to the NOLC asset prospectively from the date of the PLR.

Taxpayer requests that we rule as follows:

1. In order to avoid a violation of the normalization requirements of § 168(i)(9) and Treasury Regulation § 1.167(l)-1, it is necessary to include in rate base the Accumulated Deferred Income Tax (ADIT) asset resulting from the Net Operating Loss Carryforward (NOLC), given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.

2. The exclusion from rate base of the entire ADIT asset resulting from the NOLC, or the inclusion in rate base of a portion of that ADIT asset that is less than the amount attributable to accelerated tax depreciation, computed on a "with and without" basis, would violate the normalization requirements of § 168(i)(9) and § 1.167(l)-1.

LAW AND ANALYSIS

Section 168(f)(2) of the Code provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, § 168(i)(9)(A)(i) requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that-would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of § 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under § 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under § 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former § 167(l) generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of

service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the reserve account for deferred taxes (ADIT), reduces rate base, it is clear that the portion of the net operating loss carryover (NOLC) that is attributable to accelerated depreciation must be taken into account in calculating the amount of the ADIT account balance. Thus, the order by Commission to include in rate base the ADIT asset resulting from the NOLC, given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation is in accord with the normalization requirements.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "with or without" method would not provide the same level of certainty and therefore the use of any other methodology in computing the portion of the ADIT asset attributable to accelerated depreciation is inconsistent with the normalization rules.

We rule as follows:

1. In order to avoid a violation of the normalization requirements of § 168(i)(9) and Treasury Regulation § 1.167(l)-1, it is necessary to include in rate base the Accumulated Deferred Income Tax (ADIT) asset resulting from the Net Operating Loss Carryforward (NOLC), given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.

2. The exclusion from rate base of the entire ADIT asset resulting from the NOLC, or the inclusion in rate base of a portion of that ADIT asset that is less than the amount attributable to accelerated tax depreciation, computed on a "with and without" basis, would violate the normalization requirements of § 168(i)(9) and § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely, Patrick S. Kirwan, Chief, Branch 6, Office of the Associate Chief Counsel (Passthroughs & Special Industries).

cc: *****

STATE OF Texas §
COUNTY OF Harris §
§

AFFIDAVIT OF JENNIFER K. STORY

BEFORE ME, the undersigned authority, on this day personally appeared Jennifer K. Storey who having been placed under oath by me did depose as follows:

1. "My name is Jennifer K. Story. I am of sound mind and capable of making this affidavit. The facts stated herein are true and correct based upon my personal knowledge.

2. I have prepared the foregoing Rebuttal Testimony and the information contained in this document is true and correct to the best of my knowledge."

Further affiant sayeth not.

Jennifer K Story
Jennifer K. Story

SUBSCRIBED AND SWORN TO BEFORE ME on this 9th day of July, 2024.

Notary Public in and for the State of Texas

My commission expires: 08/05/27

CHAYLA BRIANA FRANKLIN
NOTARY ID #13211605-7
My Commission Expires
August 05, 2027

CERTIFICATE OF SERVICE

I certify that a true and correct copy of this filing has been forwarded to all parties of record via electronic mail on July 12, 2024, in accordance with the Second Order Suspending Rules, filed in Project No. 50664.

/s/Mark Santos
Mark Santos