

<b>Exhibit No.:</b>	_____
<b>Issue(s):</b>	Extraordinary Item/ Net Operating Loss Exclusion (NOL) From Rate Base
<b>Witness/Type of Exhibit:</b>	Riley/Surrebuttal
<b>Sponsoring Party:</b>	Public Counsel
<b>File No.:</b>	GR-2018-0230

**SURREBUTTAL TESTIMONY**

**OF**

**JOHN S. RILEY**

Submitted on Behalf of the Office of the Public Counsel

**SUMMIT NATURAL GAS OF MISSOURI, INC.**

FILE NO. GR-2018-0230

April 26, 2019

BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI

In the Matter of the Propriety of the Rate )  
Schedules for Natural Gas Service of ) File No. Gr-2018-0230  
Summit Natural Gas of Missouri, Inc. )

AFFIDAVIT OF JOHN S. RILEY


STATE OF MISSOURI )  
                                                          ) ss  
COUNTY OF COLE )

John S. Riley, of lawful age and being first duly sworn, deposes and states:

1. My name is John S. Riley. I am a Public Utility Accountant III for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

  
\_\_\_\_\_  
John S. Riley, C.P.A.  
Public Utility Accountant III

Subscribed and sworn to me this 26<sup>th</sup> day of April 2019.



JERENE A. BUCKMAN  
My Commission Expires  
August 23, 2021  
Cole County  
Commission #13754037

  
\_\_\_\_\_  
Jerene A. Buckman  
Notary Public

My Commission expires August 23, 2021.

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**SURREBUTTAL TESTIMONY**  
**OF**  
**JOHN S. RILEY**  
**SUMMIT NATURAL GAS OF MISSOURI, INC.**  
**CASE NO. GR-2018-0230**

1 **INTRODUCTION**

2 **Q. What is your name and what is your business address.**

3 A. John S. Riley, P.O. Box 2230, Jefferson City, Missouri 65102.

4 **Q. By whom are you employed and in what capacity?**

5 A. I am employed by the Missouri Office of the Public Counsel (“OPC”) as a Certified Public  
6 Accountant (“CPA”) in the position of Public Utility Accountant III.

7 **Q. Are you the same John S. Riley who filed direct testimony in this case?**

8 A. Yes, I am.

9 **Q. What is the purpose of your surrebuttal testimony?**

10 A. The purpose of this testimony is to respond to the rebuttal testimony of Summit Natural Gas  
11 of Missouri, Inc. (“Summit” or “Company”) witness Amanda Tolbert. I will also address the  
12 improprieties of the treatment of a Net Operating Loss (“NOL”) where Summit claims it must  
13 be included in the calculation of the utility’s Accumulated Deferred Income Tax (“ADIT”).

14 **EXTRAORDINARY ITEM**

15 **Q. What is your opinion regarding the Company’s response to Staff’s recommendation**  
16 **that an Accounting Authority Order (“AAO”) should be implemented?**

17 A. I agree with the Commission Staff’s recommendation. An AAO is appropriate and satisfies  
18 the “extraordinary” criteria generally applied to AAO requests. The federal tax rate reduction  
19 resulting from the Tax Cuts and Jobs Act of 2017 (“TCJA”) is an extraordinary event with an  
20 extraordinary impact on Summit. Before the TCJA, the last previous federal tax reduction

1 occurred in the mid-1980s and was implemented in two steps. That federal tax rate remained  
2 in effect for over thirty (30) years before the TCJA.

3 Company witness, Ms. Amanda Tolbert, however, disagrees with Staff's recommendation.  
4 She argues that a change in tax expense is not extraordinary. As an example, she uses quotes  
5 from a Commission Report & Order in Case No. WU-2017-0351 to point out that "[t]here is  
6 nothing unusual or extraordinary about paying property taxes to warrant an AAO." However,  
7 the payment of income taxes is not the subject of this case, it is the magnitude of the rate  
8 change in federal income tax laws that is extraordinary and material.

9 Ms. Tolbert refers to the FERC General Instruction No. 7 definition to support her argument  
10 that this tax change in tax law is not "extraordinary." She omits portions of the FERC  
11 definition of Extraordinary Items that do not support her assertions. The complete FERC  
12 definition of Extraordinary Item in FERC's USOA is as follows:

13 Extraordinary Items.

14 It is the intent that net income shall reflect all items of profit and loss during  
15 the period with the exception of prior period adjustments as described in  
16 paragraph 7.1 and long-term debt as described in paragraph 17 below. Those  
17 items related to the effects of events and transactions which have occurred  
18 during the current period and which are of unusual nature and infrequent  
19 occurrence shall be considered extraordinary items. **Accordingly, there will**  
20 **be events and transactions of significant effect which are abnormal and**  
21 **significantly different from the ordinary and typical activities of the**  
22 **company, and which would not reasonably be expected to recur in the**  
23 **foreseeable future.** (In determining significance, items should be  
24 considered individually and not in the aggregate. However, the effects of a  
25 series of related transactions arising from a single specific and identifiable  
26 event or plan of action should be considered in the aggregate. To be  
27 considered as extraordinary under the above guidelines, an item should be  
28 more than approximately 5 percent of income, computed before  
29 extraordinary items. Commission approval must be obtained to treat an item  
30 of less than 5 percent, as extraordinary. (See accounts 434 and 435.)  
31 (Emphasis added).<sup>1</sup>

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<sup>1</sup> Case No. WU-2017-0351, Riley rebuttal page 4, lines 6 - 25.

1 From this paragraph, I conclude that a 40% reduction in a major expense item (taxes) due to  
2 federal legislation is an extraordinary item by any stretch of reasonable inquiry.

3 **Q. The Company’s witness rejects the four original proposals made in your direct**  
4 **testimony on the grounds that the financial impact would lower earnings and “could**  
5 **limit the Company’s ability to obtain financing at attractive rates.”<sup>2</sup> How do you**  
6 **respond to Ms. Tolbert’s assertion?**

7 A. Ms. Tolbert’s assertion is based on the premise that the Company experienced negative  
8 financial results from the lowering of its income tax expense while customers’ rates were  
9 unchanged. Ms. Tolbert’s rebuttal testimony omits that the AAO only returns the Company  
10 to its pre-TCJA financial results and preserves the issue for when customer rates are affected  
11 by these income tax savings in a future rate case. It is difficult to understand how a federal  
12 tax reduction, that also lowers customers’ rates would have any impact on the Company’s  
13 ability to attract “reasonable” financing, as Ms. Tolbert’s contends. The fact is the Company’s  
14 financial results will be precisely what its earnings would be absent the TCJA impact.

15 **NET OPERATING LOSS EXCLUSION (NOL) FROM RATE BASE**

16 **Q. Summit has included an NOL in the unprotected portion of the excess ADIT. Ms.**  
17 **Tolbert has stated that to exclude the NOL from the calculation may be a violation of**  
18 **the Internal Revenue Service (“IRS”) normalization rules. Do you see the NOL**  
19 **exclusion from the ADIT as a possible violation?**

20 A. No. It is my experience that exclusion of an NOL is not an IRS violation. The IRS, in fact,  
21 only requires the Commission to consider the NOL when setting rates (see full discussion  
22 below). Review of the statutes Ms. Tolbert references in her testimony shows that an NOL  
23 has nothing to do with the normalization method of accounting in 26 CFR § 168(i)(9). (See  
24 attached JSR-S-1). While this section is tedious to read, the main point is that this

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<sup>2</sup> Tolbert rebuttal, page 6, lines 8 and 9

1 Commission sets rates based on an ADIT that does take into consideration the company's net  
2 operating losses, if any. It is important to note that an NOL does not inhibit the flow or  
3 calculation of the ADIT (whether that be an accumulation or a reduction) that is included in  
4 the Company's rate base. I have provided an example intended to help visualize how the  
5 Commission treats ADIT. (JSR-S-2)

6 **Q. Will you provide a narrative to help with the example?**

7 A. Yes. The parameters are straightforward. There is one \$ 100,000 plant asset (rate base) placed  
8 into service that has a useful life of 10 years. Actual net income is not important to show how  
9 ADIT is calculated correctly, however, \$100,000 net income will be used to help visualize the  
10 income tax accounting entries for years 1-5 and 6-10.

11 Regulatory depreciation is \$10,000 (\$100,000/10), while in contrast, for tax purposes  
12 depreciation is \$20,000 a year for five years. The accelerated depreciation for taxes creates a  
13 difference of \$2,100 in taxes payable in contrast to the income tax expense allowed in rates.  
14 This is a benefit to the utility and the Commission considers this ADIT to be interest-free  
15 money the Company may use. Accordingly, the Commission reduces rate base by this  
16 amount to reflect the Company's benefit of interest free use of this depreciation difference.  
17 This difference will occur in each of the first five years until the accelerated depreciation is  
18 exhausted and the plant has a zero value for tax purposes. The annual \$2,100 difference in  
19 taxes accumulates (ADIT) each year for the first five years, totaling \$10,500.

20 Schedule JSR-S-2 presents a simple yet accurate description of the normalization accounting  
21 established by IRS regulations. The IRS Normalization method of accounting requires that a  
22 reserve account<sup>3</sup> be established to record this difference in tax expense/payable created by  
23 the use of different depreciation methods for rates and taxes.

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<sup>3</sup> The actual USOA account would be the liability account, 281 Accumulated Deferred Income Taxes, but the account is not important for this demonstration.

1 **Q. What happens to the ADIT balance after year five?**

2 A. The tax benefit reverses and flows back through the ADIT account for the remaining  
3 regulatory life of the asset. This is the essence of the normalization principle - benefits build  
4 up with accelerated depreciation and reverse over the asset's remaining life when the  
5 accelerated depreciation expires. The key point that isn't readily apparent in the IRS  
6 regulation or in my example, is that the accumulation of deferred tax, or the after-year-five  
7 return or dispersion of the deferred tax to a utility, is not predicated on a utility's net income.

8 **Q. If net income is not a factor then how is deferred tax calculated?**

9 A. Deferred tax is calculated on the *difference* between using accelerated depreciation for taxes  
10 and the straight-line depreciation for regulatory purposes. The quotation below from *IRS*  
11 *section 168* contains no reference to income in the calculation of regulated tax expense.  
12 Instead, it requires the utility (taxpayer) to adjust a reserve to show the deferral of taxes  
13 resulting from accelerated depreciation and straight-line depreciation:

14 if the amount allowable as a deduction under this section with respect  
15 to such property (respecting all elections made by the taxpayer under  
16 this section) differs from the amount that would be allowable as a  
17 deduction under section 167 using the method (including the period,  
18 first and last year convention, and salvage value) used to compute  
19 regulated tax expense under clause (i), the taxpayer must make  
20 adjustments to a reserve to reflect the deferral of taxes resulting from  
21 such difference.<sup>4</sup>

22 To state it differently, there is no discussion of income in this paragraph, whether that income is  
23 negative or positive. Referring back to my example at JSR-S-2, income tax expense that is  
24 built into Summit's rates is developed using straight line depreciation, so the Company does  
25 not pay \$20,000, which includes the added depreciation expense used in calculating federal  
26 taxes.

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<sup>4</sup> § 168(i)(9)(ii) CFR?



1 **Q. The Summit witness has argued that “... the Internal Revenue Service (“IRS”) has**  
2 **stated that reducing rate base by the amount of the ADIT without considering the NOL**  
3 **ADIT would violate the normalization rules.”<sup>5</sup> How do you respond to that claim?**

4 A. The IRS has issued many letter rulings concerning the effects of NOLs on the balance of  
5 ADIT in a utility company’s rate base. All of them have disclaimers that these decisions are  
6 *taxpayer* specific. In the letter rulings I have read, one comment is included in nearly every  
7 one of these rulings, and it is that an NOL must be *considered* when determining the ADIT  
8 balance in rate base. The word “consider” is the important point in the ADIT balance  
9 determination. This Commission does *consider* an NOL in its determination of ADIT when  
10 the utility requests such consideration.

11 **Q. How does the Commission apply that determination?**

12 A. The Commission establishes deferred tax by calculating the tax difference between straight-  
13 line depreciation and tax-accepted-accelerated depreciation.

14 I have included IRS letter ruling PLR-201418024 as JSR-S-3. I have referred to this letter  
15 ruling in other rate case testimonies. I use it as an example now because the facts presented  
16 in the ruling are the closest description of how this Commission determines the amount of  
17 ADIT to be included in rate base. It is helpful to read this letter ruling in its entirety, but I  
18 have selected portions for quotation below. (The complete PLR is attached).

19 As I stated in the preceding answer, the Commission must *consider* an NOL in the ADIT  
20 calculation. This letter ruling also acknowledges that point but also concludes that there is no  
21 specific guidance that has to be followed:

22 In the rate case at issue, Commission has excluded from the base to  
23 which the Taxpayer’s rate of return is applied the reserve for  
24 deferred taxes, unmodified by the accounts which Taxpayer has  
25 designed to calculate the effects of the NOLCs and MTCC. **There**  
26 **is little guidance on exactly how an NOLC or MTCC must be**

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<sup>5</sup> Tolbert Rebuttal, page 9, lines 2 - 4

1                   **taken into account in calculating the reserve for deferred taxes**  
2                   **under §§ 1.167(1)-1(h)(1)(iii) and 56(a)(1)(D).** However, it is clear  
3                   that both must be taken into account in calculating the amount of the  
4                   reserve for deferred taxes (ADIT) for the period used in determining  
5                   the taxpayer's expense in computing cost of service in such  
6                   ratemaking.<sup>6</sup> (Emphasis added).

7                   The point I am making here is that an NOL deduction is not part of the IRS normalization rule  
8                   and is not included in section 168(i)(9).

9                   **Q.    What was the ultimate decision in PLR-201418024?**

10                  A.    The IRS determined that setting rates based on the balance of the ADIT account without  
11                  adjustments for an NOL does follow the normalization rules set out in section 168(i)(9). The  
12                  following states:

13                               Both Commission and Taxpayer have intended, at all relevant times,  
14                               to comply with the normalization requirements. **Commission has**  
15                               **stated that, in setting rates it includes a provision for deferred**  
16                               **taxes based on the entire difference between accelerated tax and**  
17                               **regulatory depreciation, including situations in which a utility has**  
18                               **an NOLC or MTCC. Such a provision allows a utility to collect**  
19                               **amounts from ratepayers equal to income taxes that would have**  
20                               **been due absent the NOLC and MTCC. Thus, Commission has**  
21                               **already taken the NOLC and MTCC into account in setting rates.**  
22                               Because the NOLC and MTCC have been taken into account,  
23                               Commission's decision to not reduce the amount of the reserve for  
24                               deferred taxes by these amounts does not result in the amount of that  
25                               reserve for the period being used in determining the taxpayer's  
26                               expense in computing cost of service exceeding the proper amount of  
27                               the reserve and violate the normalization requirements. We therefore  
28                               conclude that the reduction of Taxpayer's rate base by the full amount  
29                               of its ADIT account without regard to the balances in its NOLC-  
30                               related account and its MTCC-related account was consistent with the  
31                               requirements of § 168(i)(9) and § 1.167(1)-1 of the Income Tax  
32                               regulations.<sup>7</sup> (Emphasis added).

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<sup>6</sup> PLR-133813-13, page 6, first paragraph

<sup>7</sup> PLR-201418024, Page 6, second full paragraph

1 **Q. What would be the unprotected balance with the NOL excluded from the calculation?**

2 A. The NOL balance listed on Ms. Tolbert's Schedule AT-3 is marked confidential, however,  
3 the remaining balance should be amortized over a 10 year period.

4 **Q. Could you summarize your testimony?**

5 A. Yes. The impact of the TCJA on Summit was extraordinary and Summit's testimony does  
6 not demonstrate otherwise. Furthermore, in response to Summit's witness' claims that the  
7 balance of its NOL must be an offset to the ADIT balance used to reduce rate base, I have  
8 demonstrated that the ADIT balance was calculated with consideration of the NOL totals.

9 **Q. What is your recommendation?**

10 A. The Commission should lower Summit's rates by the difference of the lower federal tax  
11 rate and order a regulatory liability account to recognize the excess ADIT until the  
12 Company's next general rate case.

13 **Q. Does this conclude your surrebuttal testimony?**

14 A. Yes.

**I.R.C.: § 168(i)(9)**

**(9) Normalization rules**

**(A) In general** In order to use a normalization method of accounting with respect to any public utility property for purposes of subsection (f)(2)—

**(i)**

the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes; and

**(ii)**

if the amount allowable as a deduction under this section with respect to such property (respecting all elections made by the taxpayer under this section) differs from the amount that would be allowable as a deduction under section 167 using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

**(B) Use of inconsistent estimates and projections, etc.**

**(i) In general**

One way in which the requirements of subparagraph (A) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (A).

**(ii) Use of inconsistent estimates and projections**

The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (A)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

**(iii) Regulatory authority**

The Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in clause (ii)) which are to be treated as inconsistent for purposes of clause (i).

**(C) Public utility property which does not meet normalization rules**

In the case of any public utility property to which this section does not apply by reason of subsection (f)(2), the allowance for depreciation under section 167(a) shall be an amount computed using the method and period referred to in subparagraph (A)(i).

**Example of the Normalization of Deferred Income Tax**

10 year regulatory life with 5 year tax depreciation

\$ 100,000.00 Addition to Rate Base

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Depreciation for taxes	20,000.00	20,000.00	20,000.00	20,000.00	20,000.00	0	0	0	0	0
Tax Rate	21%	21%	21%	21%	21%	21%	21%	21%	21%	21%
Deduction in Taxes	4,200.00	4,200.00	4,200.00	4,200.00	4,200.00	0	0	0	0	0
Depreciation for Rates	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00	10,000.00
Tax Rate	21%	21%	21%	21%	21%	21%	21%	21%	21%	21%
Deduction for Rates	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00

	Tax Income	Reg Income		Reg Income	Tax Income
Hypothetical income	100,000.00	100,000.00		100,000.00	100,000.00
tax deduction	20,000.00	10,000.00		(10,000.00)	-
taxable income	80,000.00	90,000.00		90,000.00	100,000.00
	21%	21%		21%	21%
income tax	16,800.00	18,900.00	(2,100.00)	18,900.00	21,000.00

	<u>Yr 1-5</u>		<u>Yr 6-10</u>
<b>Income Tax Expense</b>	<b>18,900.00</b>		<b>18,900.00</b>
<b>income tax payable</b>		<b>16800</b>	<b>21000</b>
<b>Deferred Income Tax</b>		<b>2100</b>	<b>2100</b>

<b>The Accumulation and Reduction of Deferred Income Tax - Normalization Accounting</b>										
Accumulating Deferred Tax		2,100.00	4,200.00	6,300.00	8,400.00	10,500.00	8,400.00	6,300.00	4,200.00	2,100.00
Annual Add/Reduction	2,100.00	2,100.00	2,100.00	2,100.00	2,100.00	(2,100.00)	(2,100.00)	(2,100.00)	(2,100.00)	(2,100.00)
Rate Base Deduction	2,100.00	4,200.00	6,300.00	8,400.00	10,500.00	8,400.00	6,300.00	4,200.00	2,100.00	-

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **201418024**  
Release Date: 5/2/2014  
Index Number: 167.22-01

Third Party Communication: None  
Date of Communication: Not Applicable

Person To Contact:  
, ID No.

Telephone Number:

Refer Reply To:  
CC:PSI:B06  
PLR-133813-13  
Date:  
January 27, 2014

LEGEND:

- Taxpayer =
- Parent =
- State =
- Commission =
- Year A =
- Year B =
- Year C =
- Year D =
- Year E =
- X =
- Y =
- Date A =
- Date B =
- Date C =
- Date D =
- Date E =
- Case =
- Director =

Dear . :

This letter responds to the request, dated July 30, 2013, of Taxpayer for a ruling on whether the Commission's treatment of Taxpayer's Accumulated Deferred Income

Tax (ADIT) account balance in the context of a rate case is consistent with the requirements of the normalization provisions of the Internal Revenue Code.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State. It is wholly owned by Parent. Taxpayer distributes and sells natural gas to customers in State. 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 takes accelerated depreciation where available and, for the period beginning in Year A and ending in Year E, Taxpayer has, in the aggregate, produced more net operating losses (NOL) than taxable income. After application of the carryback and carryforward rules, Taxpayer represents that it has net operating loss carryforward (NOLC), produced in Year C and Year E, of \$X as of the end of Year E. The amount of claimed accelerated depreciation in Year C and Year E exceeded the amount of the NOLCs for those years. In Year D, Taxpayer produced regular taxable income as well as alternative minimum taxable income (AMTI); the regular taxable income was offset by the NOLCs from Year B and year C but could not offset the entire alternative minimum tax (AMT) liability due to the limitation in § 56(d). Taxpayer paid \$Y of AMT in Year D and had a minimum tax credit carryforward (MTCC) as of the end of year E of \$Y.

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 and also maintains an offsetting series of entries 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. With respect to the \$Y AMT liability from Year D, Taxpayer carried that amount as an offset to the ADIT because the AMT increased the payment of tax.

Taxpayer filed a general rate case on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In establishing the income tax expense element of its 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 generally offsets rate base by Taxpayer’s plant based 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

NOLCs or the AMT. Commission, in an order issued on Date C, did not use the amounts that Taxpayer calculates did not defer tax due to NOLCs or AMT but only the amount in the ADIT account. Taxpayer filed a petition for reconsideration based on the normalization implications of the order. On Date D, Commission rejected Taxpayer's request. Taxpayer again requested reconsideration and the Commission denied that request on Date E. Commission asserts that, in setting rates it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has, such as in this case, an NOLC or AMT. Thus, Commission asserts that it has already recognized the effects of the NOCL in setting rates and there is no need to reduce the ADIT by the other amounts due to NOLCs or AMT.

Taxpayer requests that we rule as follows:

Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account without regard to the balances in its NOLC-related account and its MTCC-related account was consistent with 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(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 55 of the Code imposes an alternative minimum tax on certain taxpayers, including corporations. Adjustments in computing alternative minimum taxable income are provided in § 56. Section 56(a)(1) provides for the treatment of depreciation in computing alternative minimum taxable income. 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(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 the rate case at issue, Commission has excluded from the base to which the Taxpayer's rate of return is applied the reserve for deferred taxes, unmodified by the accounts which Taxpayer has designed to calculate the effects of the NOLCs and MTCC. There is little guidance on exactly how an NOLC or MTCC must be taken into account in calculating the reserve for deferred taxes under §§ 1.167(1)-1(h)(1)(iii) and 56(a)(1)(D). However, it is clear that both must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT) for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Both Commission and Taxpayer have intended, at all relevant times, to comply with the normalization requirements. Commission has stated that, in setting rates it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or MTCC. Such a provision allows a utility to collect amounts from ratepayers equal to income taxes that would have been due absent the NOLC and MTCC. Thus, Commission has already taken the NOLC and MTCC into account in setting rates. Because the NOLC and MTCC have been taken into account, Commission's decision to not reduce the amount of the reserve for deferred taxes by these amounts does not result in the amount of that reserve for the period being used in determining the taxpayer's expense in computing cost of service exceeding the proper amount of the reserve and violate the normalization requirements. We therefore conclude that the reduction of Taxpayer's rate base by the full amount of its ADIT account without regard to the balances in its NOLC-related account and its MTCC-related account was consistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In particular, while we accept as true for purposes of this ruling Commission's assertions that it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or AMT, we do not conclude that it has done so and those assertions are subject to verification on audit.

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: