

DOCKET NO. \_\_\_\_\_

APPLICATION OF SOUTHWESTERN § PUBLIC UTILITY COMMISSION  
PUBLIC SERVICE COMPANY FOR §  
AUTHORITY TO CHANGE RATES § OF TEXAS

DIRECT TESTIMONY  
*of*  
NAOMI KOCH

*on behalf of*

SOUTHWESTERN PUBLIC SERVICE COMPANY

(Filename: KochRRDirect.doc)

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## **GLOSSARY OF ACRONYMS AND DEFINED TERMS**

<b><u>Acronym/Defined Term</u></b>	<b><u>Meaning</u></b>
ADIT	Accumulated Deferred Income Taxes
Commission	Public Utility Commission of Texas
CWIP	Construction Work in Progress
FERC	Federal Energy Regulatory Commission
GAAP	Generally Accepted Accounting Principles
IRC	Internal Revenue Code
IRS	Internal Revenue Service
ITC	Investment Tax Credit
NOL	Net Operating Loss
NOL carryforward	NOL-related deferred tax asset
NSPM	Northern States Power Company, a Minnesota corporation
PATH ACT	Protecting Americans from Tax Hikes Act
PLR	Private Letter Ruling
PTC	Production Tax Credit
R&E	Research and Experimentation
RFP	Rate Filing Package
SPS	Southwestern Public Service Company, a New Mexico corporation
Test Year	April 1, 2016 through March 31, 2017
Total Company	Total SPS (before jurisdictional allocators)
Update Period	April 1, 2017 through June 30, 2017

<b><u>Acronym/Defined Term</u></b>	<b><u>Meaning</u></b>
Updated Test Year	July 1, 2016 through June 30, 2017
Xcel Energy	Xcel Energy Inc.
XES	Xcel Energy Services Inc.

## LIST OF ATTACHMENTS

<u>Attachment</u>	<u>Description</u>
NK-RR-1(V)	Internal Revenue Code § 168 and 26 C.F.R. § 1.167 (Non-native format)
NK-RR-2	Private Letter Ruling 201438003 (Non-native format)
NK-RR-3	Private Letter Ruling 201436038 (Non-native format)
NK-RR-4	Private Letter Ruling 201436037 (Non-native format)
NK-RR-5	SPS Property Tax Calculation (Filename: Attachment NK-RR-5.xlsx)

**DIRECT TESTIMONY  
OF  
NAOMI KOCH**

1           **I.       WITNESS IDENTIFICATION AND QUALIFICATIONS**

2   **Q.       Please state your name and business address.**

3   A.       My name is Naomi Koch. My business address is 414 Nicollet Mall, Minneapolis,  
4           Minnesota 55401.

5   **Q.       On whose behalf are you testifying in this proceeding?**

6   A.       I am filing testimony on behalf of Southwestern Public Service Company, a New  
7           Mexico corporation (“SPS”) and wholly-owned electric utility subsidiary of Xcel  
8           Energy Inc. (“Xcel Energy”).

9   **Q.       By whom are you employed and in what position?**

10  A.       I am employed by Xcel Energy Services Inc. (“XES”), the service company  
11           subsidiary of Xcel Energy, as Manager, Tax Reporting.

12  **Q.       Please briefly describe your duties as Manager, Tax Reporting.**

13  A.       I oversee federal and state income tax compliance and accounting for all Xcel Energy  
14           group companies.

15  **Q.       Please describe your educational background.**

16  A.       I earned a Bachelor of Science degree from the University of Minnesota and a  
17           Masters of Business Taxation degree from the University of Minnesota.

18  **Q.       What is your professional experience?**

19  A.       I have over eighteen years of corporate tax experience with XES and the former  
20           Northern States Power Company, a Minnesota corporation (“NSPM”). I joined  
21           NSPM in 1999 in Tax Services. In 2008, I was promoted to my current position.

1 Through this experience, I have become familiar with various provisions of the  
2 Internal Revenue Code (“IRC”) and Internal Revenue Service (“IRS”) regulations  
3 (also referred to as rules) that affect public utilities. I also have become familiar with  
4 various state laws, utility commission rules, and court cases that relate to the  
5 treatment and calculation of tax expenses, including income tax, for ratemaking and  
6 utility regulatory purposes, including those of Texas.

7 **Q. Have you taken courses related to public utilities?**

8 A. Yes. I have taken several courses related to accounting and taxation of public  
9 utilities offered by the Edison Electric Institute, the American Gas Association,  
10 Deloitte & Touche, PricewaterhouseCoopers, and Arthur Andersen.

11 **Q. Are you a member of any professional organizations?**

12 A. Yes. I am a member of Tax Executives Institute, an association of in-house business  
13 tax professionals worldwide.

14 **Q. Have you filed testimony before any regulatory authorities?**

15 A. Yes. I have filed testimony before the Public Utility Commission of Texas  
16 (“Commission”) in Docket No. 45524 regarding bonus depreciation, income tax  
17 issues, accumulated deferred income taxes (“ADIT”), and property taxes. I have also  
18 filed testimony on behalf of SPS on those same issues before the New Mexico Public  
19 Regulation Commission in Case Nos. 16-00269-UT and 15-00296-UT, both of which  
20 were base rate cases.

1                   **II.     ASSIGNMENT AND SUMMARY OF CONCLUSIONS**

2     **Q.     What is your assignment in this testimony?**

3     A.     I have several assignments in this testimony. First, I support the amounts of federal  
4             and state income tax expense included in SPS's cost of service and the amount of  
5             ADIT reflected in SPS's rate base.

6             Second, I describe the normalization rules prescribed by the IRC and  
7             Treasury Regulations implementing the IRC, and I explain that SPS has calculated its  
8             rates consistent with those normalization requirements.

9             Third, I discuss the implications of the federal tax legislation that was passed  
10            in December 2015, which has temporarily extended bonus depreciation and certain  
11            federal investment and production tax credits. That legislation also permanently  
12            extended the federal Research and Experimentation ("R&E") credit, which affects  
13            SPS's requested income tax expense and ADIT balance.

14            Fourth, I quantify the amount of property taxes in the Test Year<sup>1</sup> and the  
15            Update Period<sup>2</sup>, and I explain the adjustments to property taxes.

16            Finally, I sponsor or co-sponsor many of the G-7 schedules included in SPS's  
17            rate filing package ("RFP"), which address federal income tax, and I sponsor the two  
18            G-9 schedules, which address property tax. I will discuss those schedules in more  
19            detail in the next section of my testimony. I also sponsor or co-sponsor the portions  
20            of the Executive Summary that contain information from the schedules that I  
21            sponsor.

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<sup>1</sup> Test Year is the period April 1, 2016 through March 31, 2017.

<sup>2</sup> Update Period is the period April 1, 2017 through June 30, 2017.

1     **Q.     Please summarize the conclusions and recommendations in your testimony.**

2     **A.     Income Taxes** – Along with SPS witness Melissa L. Ostrom, I assisted SPS witness  
3     Arthur P. Freitas in calculating the income tax expense and the ADIT balance  
4     included in the cost of service and rate base, respectively. The accounting principles  
5     underlying both the requested amount of income tax expense and the ADIT balance  
6     reflected in rate base comply with Generally Accepted Accounting Principles  
7     (“GAAP”), the Federal Energy Regulatory Commission (“FERC”) Uniform System  
8     of Accounts (which is used by the Commission), and Commission precedent.

9             The requested income taxes included in the cost of service and the amount of  
10     ADIT reflected in rate base comply with the normalization requirements of the IRC  
11     and Treasury Regulations. SPS has complied with the normalization rules because  
12     failure to do so would ultimately harm SPS’s customers by increasing the amount of  
13     rate base on which customers pay a return.

14            As discussed later in my testimony, a net operating loss (“NOL”) occurs  
15     when a company’s allowable tax deductions exceed its taxable income, resulting in  
16     negative taxable income. SPS’s use of accelerated depreciation (e.g., bonus  
17     depreciation) has resulted in SPS experiencing NOLs in previous years. SPS did not  
18     experience an NOL during the Test Year or Updated Test Year (“July 1, 2016  
19     through June 30, 2017”), but the NOLs carried forward from prior years have created  
20     a deferred tax asset that SPS has used to reduce taxable income in the Updated Test  
21     Year to zero. Thus, for financial reporting purposes, SPS had no current income tax  
22     expense for the Test Year or Updated Test Year.



1           For purposes of setting rates, however, SPS's federal income tax expense  
2           must be calculated as though SPS had used straight-line depreciation.<sup>3</sup> Calculating  
3           the federal income tax expense included in SPS's rates using accelerated  
4           depreciation would violate IRS normalization rules, which would disqualify SPS  
5           from using accelerated depreciation and would increase the rate base on which SPS's  
6           customers pay a return.

7           In addition, SPS's ADIT balance should be offset by the NOL-related  
8           deferred tax asset (which is typically referred to as an "NOL carryforward") that  
9           results from SPS's inability to currently benefit from all of the accelerated  
10          depreciation deductions it claimed in the Test Year and Update Period. Failure to  
11          offset the tax-affected NOL carryforward against the ADIT balance would also give  
12          rise to a normalization violation, with the same adverse consequences discussed  
13          earlier.

14          I also discuss the R&E credit balance included in the cost of service. SPS has  
15          also included in rate base a deferred tax asset associated with the R&E credit.

16          I also recommend that the Commission approve SPS's request to recover a  
17          jurisdictional share of SPS's state income taxes and its Texas jurisdictional share of  
18          the Texas gross margin tax, in its cost of service.

19          **Property Taxes** – I recommend that the Commission approve SPS's requested  
20          property tax amount, including the property tax adjustments discussed in my  
21          testimony. At this time, SPS is requesting \$42,896,526 (total company) for property

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<sup>3</sup> In contrast to accelerated depreciation, straight-line depreciation recovers the cost of an asset in equal amounts each year over the asset's expected productive life. Straight-line depreciation is used for

1 taxes. SPS has adjusted its estimated amount of property tax expense to reflect  
2 property taxes associated with construction work in progress (“CWIP”) by removing  
3 \$703,474 (total company) from property tax expense and adding that amount to rate  
4 base. SPS placed that amount in rate base to reflect the Commission’s ruling in  
5 Docket No. 43695 that property taxes on plant that has not yet been placed in service  
6 be capitalized.<sup>4</sup>

7 **Q. Will your testimony be updated for actual costs incurred in the three months**  
8 **following the Test Year, April through June 2017, the Update Period?**

9 A. Yes. A portion of my testimony will be updated. As discussed by SPS witness  
10 William A. Grant, SPS will file an update 45 days after SPS files this application.  
11 The update will include actual costs incurred to replace the estimates provided in the  
12 application for the period of April 1, 2017 through June 30, 2017, referred to as the  
13 “Update Period.” To the extent an updated number is available, SPS will update its  
14 R&E credit to the amounts included in its 2016 federal income tax return in the 45-  
15 day update filing. Other income tax amounts may also change.

16 **Q. Are Attachments NK-RR-1(V)(CD) through NK-RR-4 true and correct copies**  
17 **of the documents that you describe in your testimony?**

18 A. Yes.

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financial accounting and regulatory purposes.

<sup>4</sup> *Application of Southwestern Public Service Company for Authority to Change Rates*, Docket No. 43695 (Feb. 23, 2016).

1   **Q.**    Was Attachment NK-RR-5 prepared by you or under your direct supervision  
2           and control?

3   A.    Yes.

4   **Q.**    Were the RFP schedules and the portions of the Executive Summary to the RFP  
5           that you are sponsoring or co-sponsoring prepared by you or under your  
6           supervision and control?

     A.    Yes.

7   **Q.**    Do you incorporate the RFP schedules and the portion of the Executive  
8           Summary shown to be sponsored or co-sponsored by you into your testimony?

9   A.    Yes.

1 **III. SCHEDULES SPONSORED**

2 **Q. You testified earlier that you sponsor the G-7 schedules, which address income**  
3 **tax. Please summarize the G-7 schedules and explain whether they are**  
4 **applicable in this case.**

5 **A.** I sponsor the following G-7 schedules:

- 6 • Schedule G-7.1 includes a reconciliation of book net income and taxable net  
7 income for the Test Year and for the most recent year for which a tax return  
8 was filed. I co-sponsor this schedule along with Ms. Ostrom.
- 9 • Schedule G-7.1a includes a reconciliation detailing the timing differences  
10 and other items that would produce an income tax at a rate differing from the  
11 statutory rate. I co-sponsor this schedule with Ms. Ostrom.
- 12 • Schedules G-7.3, G-7.3a, and G-7.3b address consolidated tax savings  
13 adjustments. Because of a 2013 amendment to Section 36.060 of the Public  
14 Utility Regulatory Act, SPS is no longer subject to a consolidated tax savings  
15 adjustment, and therefore these schedules are not applicable to SPS.
- 16 • Schedule G-7.4 provides the year-end ADIT balances for the Test Year,  
17 including the book balance, the requested adjustments to the balances, and  
18 the resulting adjusted ADIT balances. I co-sponsor this schedule with Mr.  
19 Freitas and Ms. Ostrom.
- 20 • Schedule G-7.4a includes a description of the nature of each timing  
21 difference listed in Schedule G-7.4. I co-sponsor this schedule with Ms.  
22 Ostrom.
- 23 • Schedule G-7.4b provides supporting explanations and detailed calculations  
24 for each adjustment to the Test Year year-end balances in Schedule G-7.4. I  
25 co-sponsor this schedule with Mr. Freitas and Ms. Ostrom.
- 26 • Schedule G-7.4c provides ADIT balances and Investment Tax Credit (“ITC”)  
27 balances at year-end related to additions to new generating plant in service  
28 and any plant adjustments to the year-end balances. I co-sponsor this  
29 schedule with Ms. Ostrom.
- 30 • Schedule G-7.4d provides detail related to ADIT associated with rate-case  
31 expenses. I co-sponsor this schedule with Mr. Freitas.
- 32 • Schedules G-7.5 through G-7.5e address ITCs. SPS did not generate or  
33 utilize any ITCs during the Test Year. All ITCs included in the schedules are

- 1 amortizations from prior years in which SPS generated or utilized ITCs. I  
2 co-sponsor these schedules with Ms. Ostrom.
- 3 • Schedule G-7.6 provides an analysis of income tax calculated using Tax  
4 Method 2. I co-sponsor this schedule with Ms. Ostrom and Mr. Freitas.
  - 5 • Schedule G-7.6a provides support for the Total Deferred Income Taxes found  
6 on Schedule G-7.6. I co-sponsor this schedule with Ms. Ostrom and Mr.  
7 Freitas.
  - 8 • Schedule G-7.8 provides an analysis of income tax calculated using Tax  
9 Method 1. I co-sponsor this schedule with Ms. Ostrom and Mr. Freitas.
  - 10 • Schedule G-7.10 is not applicable to SPS because it does not have accounting  
11 order (cost) deferrals. I co-sponsor this schedule with Ms. Ostrom.
  - 12 • Schedules G-7.12 and G-7.12a are not applicable because SPS is not  
13 requesting a rate moderation plan.
  - 14 • Schedule G-7.13 contains a list of testimony addressing income taxes and  
15 ADIT. I co-sponsor this schedule with Ms. Ostrom and Mr. Freitas.
  - 16 • Schedule G-7.13a contains a discussion of SPS's history of normalization.
  - 17 • Schedule G-7.13b lists the tax elections made since the test year in SPS's  
18 prior base rate case.
  - 19 • Schedule G-7.13c explains that there have been no changes to SPS's  
20 accounting for deferred income tax since the end of the test year in SPS's last  
21 base rate case. I co-sponsor this schedule with Ms. Ostrom.
  - 22 • Schedule G-7.13d explains SPS's IRS audit status.
  - 23 • Schedule G-7.13e explains that SPS has not requested or received any private  
24 letter rulings since its last base rate case.
  - 25 • Schedule G-7.13f describes SPS's method for accounting for ADIT related to  
26 NOL carryforwards.

27 **Q. Please summarize the Schedule G-9 schedules that you sponsor or co-sponsor.**

28 A. I co-sponsor Schedule G-9, which lists and explains all taxes other than income  
29 taxes, including property taxes and gross receipts taxes. Mr. Freitas co-sponsors this  
30 schedule.

1           I also sponsor Schedule G-9.1, which lists the ad valorem taxes assessed,  
2           penalties paid, and discounts taken for the three calendar years before the Test Year.  
3           The schedule also contains the plant balances at the beginning of each of those three  
4           years.

1                                    **IV.     ACCOUNTING FOR INCOME TAXES**

2     **Q.     What topics do you discuss in this section of your testimony?**

3     A.     I discuss the calculation of SPS's income tax expense included in the cost of service.

4             I also explain how the ADIT balance is created.

5     **A.     Calculation of Income Taxes and ADIT**

6     **Q.     Did you participate in the calculation of the income tax expense and ADIT**  
7             **balance included in SPS's cost of service?**

8     A.     Yes. Ms. Ostrom and I provided information to and assisted Mr. Freitas in the  
9             calculation of the income tax expense and ADIT balances included in SPS's cost of  
10            service. Along with Ms. Ostrom, I ensured that the tax calculations were correct and  
11            did not violate Treasury normalization rules, which I will discuss in more detail later  
12            in my testimony.

13    **Q.     What standards did you follow when calculating the income tax and ADIT**  
14             **balances?**

15    A.     I followed GAAP, the FERC Uniform System of Accounts, the IRC, including  
16             associated Treasury Regulations and IRS guidance, and Texas precedent concerning  
17             the treatment of taxes in a utility's cost of service.

18    **Q.     Please describe the general process used to calculate SPS's income tax expense**  
19             **for ratemaking purposes.**

20    A.     SPS calculates its income tax expense through a multi-step process:

21             1. SPS first totals its operating expenses, including interest payments and  
22             straight-line book depreciation expense, and then it subtracts those operating  
23             expenses from total revenues to arrive at the net income before income taxes.

24             2. SPS next calculates the additions to or deductions from net income that result  
25             from temporary and permanent tax differences. That amount is then added to

- 1 the net income calculated above to arrive at federal taxable income before  
2 state income taxes.
- 3 3. State income taxes are calculated similarly. Net income is adjusted for  
4 temporary and permanent additions and deductions to arrive at state taxable  
5 income. This income is then allocated to the respective state using an  
6 apportionment percentage (each state calculates apportionment slightly  
7 different, but apportionment percentages are generally based on a ratio of the  
8 company's sales, property, and/or payroll in a state to its sales, property,  
9 and/or payroll everywhere). The apportioned state taxable income is then  
10 multiplied by the applicable state tax rate to arrive at the current state income  
11 tax.
- 12 4. The state income taxes are then added to or subtracted from the taxable  
13 income before state taxes to arrive at the federal taxable income, and the net  
14 of that amount is multiplied by the federal income tax rate. The product of  
15 that calculation is the current federal income tax.
- 16 5. If the taxable income referenced above is negative, it indicates an NOL that  
17 can be carried forward (or backward) to offset future taxable income.
- 18 6. To arrive at the total income tax expense, SPS adds federal and state current  
19 income tax expense, federal and state deferred income tax expense, and ITCs.

20 **Q. In the second step of that process, you refer to “temporary differences.” Please**  
21 **explain how temporary differences arise.**

22 A. Generally speaking, temporary differences arise when SPS collects tax expense from  
23 customers in one period, but pays the associated tax expense to the IRS in a different  
24 period. The most common example involves depreciation expense, which is  
25 typically accelerated for tax purposes, but not for ratemaking purposes. The use of  
26 accelerated depreciation reduces SPS's taxable income, which defers taxes until a  
27 later time. For purposes of setting rates, however, SPS calculates its tax expense as  
28 though it had used a straight-line book depreciation method. Thus, SPS recovers  
29 income tax expense from customers on a “normalized” basis, which results in SPS  
30 collecting income tax expense that is not paid to the IRS until a later time. That  
31 leads to the ADIT balance that I referenced earlier in my testimony.



1    **Q.    Please provide an example of how the ADIT balance accrues.**

2    A.    Suppose a utility had taxable income of \$1,000 and a federal income tax rate of 35%.  
3           In the absence of any other factors, the utility would collect \$350 from its customers  
4           as federal income tax expense, and it would pay the IRS \$350 in federal income  
5           taxes.

6           Now suppose the same facts, except that accelerated depreciation has given  
7           the utility enough depreciation expense to offset the entire \$1,000 of taxable income.  
8           The utility still collects the \$350 from its customers because of normalization rules,  
9           but it does not have to pay that amount to the IRS until some later date when the  
10          utility has taxable income. In effect, the utility is given an interest-free loan from the  
11          federal government, but the utility must record that \$350 interest-free loan as  
12          deferred income tax expense, or ADIT.

13   **Q.    Does SPS experience temporary differences in any context other than**  
14   **accelerated depreciation?**

15   A.    Yes. SPS experiences a number of non-plant temporary differences, such as costs  
16          associated with pension expense, fuel expense, and many other types of expenses or  
17          revenues. Some of those temporary differences result in deferred tax assets, and  
18          some result in deferred tax liabilities. The net cumulative amount represents SPS's  
19          ADIT balance.

1   **Q.    How is the ADIT balance reflected in rate base?**

2    A.    The ADIT balance will eventually have to be paid to the IRS and corresponding state  
3           agencies because accelerated depreciation creates only a temporary timing  
4           difference. That is why the ADIT balance is considered to be a deferral of tax  
5           liability, not a reduction of tax liability. Until the ADIT balance is paid back to the  
6           IRS and corresponding state agencies, it is used as a dollar-for-dollar reduction of  
7           rate base. In effect, the utility is receiving an interest-free loan from the federal  
8           government in the form of the ADIT balance, and, therefore, it does not need a return  
9           on an equivalent amount of rate base.

10   **B.    Federal and State Income Tax Rates**

11   **Q.    Are you using the 34% tax rate provided in the Electric Utility Rate Filing**  
12       **Package instructions?**

13    A.    No.

14   **Q.    What income tax rate are you using?**

15    A.    SPS is using a 35% federal corporate income tax rate and a 0.9224% state composite  
16           income tax rate.

17   **Q.    Is this a change from how SPS has calculated its income tax expense in its prior**  
18       **Texas rate cases?**

19    A.    Yes. SPS is proposing to modify the method in which tax expense and ADIT are  
20           calculated in the cost of service and rate base. In previous rate cases, ADIT balances  
21           were calculated by multiplying the timing differences by the 35% federal tax rate.  
22           For further discussion on the calculation of ADIT, please refer to the direct testimony  
23           of Ms. Ostrom.

1   **Q.     Why are these rates appropriate?**

2   A.     The 35% tax rate is the appropriate rate for federal corporate income taxes because  
3           that has been the effective rate since January 1, 1993, and that is still the effective  
4           rate. Thus, that is the rate that applied to SPS during the Test Year and Update  
5           Period. Including the 0.9224% state composite income tax rate more fairly  
6           represents SPS's cost of doing business.

7   **Q.     How were these income tax rates calculated?**

8   A.     For the federal income tax rate, SPS is using the corporate income tax rate currently  
9           in effect, which is 35%. For the state income tax rate, SPS has calculated a  
10          composite rate based upon the state income tax rates for the states in which SPS has  
11          presence. For state income tax purposes, presence is generally driven by property or  
12          payroll, and this presence generally obligates SPS to pay income taxes in those  
13          states. These states include Colorado, Kansas, Michigan, New Mexico, and  
14          Oklahoma.<sup>5</sup> SPS multiplies each state's corporate income tax rate by SPS's  
15          apportionment factor for the associated taxing jurisdiction. The apportionment factor  
16          is determined annually when SPS files its state income tax returns. SPS then adjusts  
17          the apportioned state income tax rate to account for the federal income tax benefit  
18          resulting from each state's income tax expense. All of SPS's apportioned state  
19          income tax rates are then added together to arrive at SPS's composite state income  
20          tax rate.

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<sup>5</sup> Although SPS had payroll (i.e. "presence") in Colorado and Michigan in 2015, the payroll did not result in an apportionment factor in the 2015 Colorado and Michigan returns. Therefore, SPS did not include a Colorado or Michigan income tax rate in its composite income tax rate.

For example, Kansas's corporate income tax rate is 7%, and 0.3312 % of SPS's total income was apportioned to Kansas in SPS's 2015 income tax return. The product of these numbers results in an apportioned tax rate of 0.0232% (i.e., 7% x 0.3312% = 0.0232%). The state apportioned tax rate is then reduced by the federal corporate rate of 35% to reflect the federal deductibility of state income taxes. The resulting rate, 0.0151%, is the apportioned state income tax rate for Kansas (i.e. 0.0232% x (1 - 35%) = 0.0151%).

SPS's federal plus composite state income tax rate can be reconciled as follows:

**Table NK-RR-1**  
**Composite State Income Tax Rate**

	A. JURISDICTIONAL TAX RATE in EFFECT at JUNE 30, 2017	B. STATE APPORTIONMENT per 2015 STATE INC. TAX RETURNS	C. APPORTIONE D TAX RATE (columns A x B)	D. FEDERAL DEDUCTION FOR STATE TAXES (column Cx-35%)	E. COMPOSITE INCOME TAX RATE (column C + D)
Federal	35%	N/A	35%	N/A	35%
Colorado	4.63%	0.0000%	0.0000%	0.0000%	0.0000%
Kansas	7.00%	0.3312%	0.0232%	-0.0081%	0.0151%
Michigan	6.00%	0.0000%	0.0000%	0.0000%	0.0000%
New Mexico	6.20%	22.0114%	1.3647%	-0.4776%	0.8871%
Oklahoma	6.00%	0.5182%	0.0311%	-0.0109%	0.0202%
Total State Income Tax Rate					0.9224%
<b>Total Composite Income Tax Rate</b>					<b>35.9224%</b>

**Q. Why is SPS including state income taxes for jurisdictions outside of Texas?**

A. SPS is including state income taxes for each of its taxing jurisdictions in which it has property or payroll (i.e., employees). As stated above, property and payroll generally

1 cause state presence for state income tax purposes, which obligates SPS to pay  
2 income taxes in those jurisdictions. SPS's property and payroll in each of these states  
3 are integral to SPS serving its retail customers in Texas. Therefore, SPS is including  
4 state income taxes for these other jurisdictions.

5 **Q. Is SPS including any other state income taxes in this rate case?**

6 A. Yes. SPS is also including the Texas Gross Margin Tax. The Texas Gross Margin  
7 Tax is not denominated as a state income tax, but it is functionally equivalent to a  
8 state income tax, and therefore SPS treats it as an income tax for ratemaking  
9 purposes.

10 **Q. What is the Texas Gross Margin Tax?**

11 A. The Texas Gross Margin Tax, which is sometimes referred to as a "franchise tax," is  
12 a tax imposed by the State of Texas. The margin tax is assessed at 0.75% of Texas-  
13 sourced taxable margin. The taxable margin is computed as the lesser of:

14 (1) 70% of total revenue; or

15 (2) total revenue less:

16 (a) cost of goods sold;

17 (b) compensation; or

18 (c) one million dollars.

19 For SPS, the lower tax has generally resulted from option 2(a). The resulting  
20 "margin" is then apportioned to Texas based on the percent of gross receipts the  
21 company earns in the state.

1   **Q.     What basis did SPS use to calculate the gross margin tax expense it is seeking to**  
2       **include in its cost of service in this case?**

3   A.     SPS calculated the gross margin tax amount included in the cost of service based on  
4       its 2016 Texas Franchise Tax Return, which is based on 2015 actual financials. That  
5       amount is \$2,157,220, net of federal taxes (total company).

6   **Q.     Have ADIT and deferred taxes in the cost of service been adjusted for the Gross**  
7       **Margin Tax?**

8   A.     Yes. As discussed earlier, SPS's Texas Gross Margin Tax is generally calculated as  
9       total revenue less the cost of goods sold. Therefore, Texas deferred taxes are  
10       recorded for temporary differences associated with revenue and with the cost of  
11       goods sold, including certain types of depreciation. These Texas deferred taxes are  
12       included as an adjustment to rate base and as part of the deferred tax expense  
13       included in the cost of service.

14   **Q.     Are SPS's Texas customers bearing the full burden of SPS's state income taxes?**

15   A.     No. SPS's Texas retail customers are getting charged only for their Texas retail  
16       jurisdictional share of the total state income tax expense, similar to how Texas  
17       customers are only getting charged the Texas retail jurisdictional portion of SPS's  
18       federal income tax expense. The Texas retail customer share is assessed using the  
19       jurisdictional allocators detailed in the cost of service.

20   **Q.     Has SPS incorporated any rate changes that might occur in the future?**

21   A.     No. SPS is using the federal and state income tax rates in effect at June 30, 2017. It  
22       would not be appropriate to incorporate any rate changes resulting from future  
23       legislation or tax reform until such changes are enacted and in effect. If and when

1 federal or state income tax rates change, SPS will assess the impact to customers and  
2 incorporate the change into this and any future rate filings. Please refer to Ms.  
3 Ostrom's testimony for additional discussion on this topic.

1       **V.       THE ROLE OF NORMALIZATION IN UTILITY RATEMAKING**

2       **Q.       What topics do you discuss in this section of your testimony?**

3       A.       I explain the steps that SPS took as part of its federal income tax calculation to avoid  
4               violating Treasury normalization rules, and I explain that it is necessary to avoid  
5               normalization violations.

6       **A.       Normalization and Income Tax Accounting**

7       **Q.       Please explain what “normalization” means in the context of utility accounting.**

8       A.       Normalization refers to a method of accounting in which the tax benefits associated  
9               with depreciation of utility assets are spread over the same period that the costs of  
10              those assets are recovered from customers. For example, if rates are set based on  
11              straight-line book depreciation, the federal income tax expense included in those  
12              rates must also be calculated as though the utility used straight-line book  
13              depreciation. The difference between the federal income tax expense calculated  
14              using accelerated depreciation and the federal income tax expense calculated using  
15              straight-line book depreciation is recorded as a deferred tax liability. The cumulative  
16              deferred tax liability balance is recorded as ADIT and serves as an offset to rate base.

17      **Q.       What is the source of the tax normalization rules?**

18      A.       Tax normalization rules come from various sources including the IRC, Treasury  
19               Regulations, and related guidance provided by the IRS, such as Private Letter  
20               Rulings (“PLR”).

21               Specifically, Congress mandated normalization for public utilities in IRC  
22               § 168(i)(9)-(10), which provides that in order to use a normalization method of  
23               accounting with respect to public utility property:



1 the taxpayer must, in computing its tax expense for purposes of  
2 establishing its cost of service for ratemaking purposes and reflecting  
3 operating results in its regulated books of account, use a method of  
4 depreciation with respect to such property that is the same as, and a  
5 depreciation period for such property that is no shorter than, the  
6 method and period used to compute its depreciation expense for such  
7 purposes.<sup>6</sup>

8 The rule requiring a utility to calculate federal income tax expense on a normalized  
9 basis is Section 1.167(l)-1 of the Treasury Regulations. Copies of the normalization  
10 statute and rule are attached to my testimony as Attachment NK-RR-1(V)(CD).

11 **Q. Earlier you referenced straight-line depreciation. What is straight-line**  
12 **depreciation?**

13 A. Straight-line depreciation is a method of depreciation which recovers the cost of an  
14 asset in equal amounts each year over the asset's expected productive life. As is the  
15 case in most jurisdictions, the Commission uses straight-line book depreciation for  
16 the purpose of computing a utility's depreciation expense in Texas.

17 **Q. What is your understanding of why Congress enacted the normalization**  
18 **requirements?**

19 A. It is my understanding that Congress's primary purpose in allowing accelerated  
20 depreciation was to stimulate investment in capital assets, such as electricity  
21 production, transmission, and distribution assets. If a utility were required to  
22 immediately pass through all tax benefits resulting from accelerated depreciation  
23 using flow-through accounting, utilities would have decreased incentives to invest in  
24 the capital assets that give rise to accelerated depreciation. Additionally, using

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<sup>6</sup> IRC § 168(i)(9)(A)(i).

1 flow-through accounting would create intergenerational inequity because current  
2 customers would receive a benefit that should be spread over the life of the asset.  
3 Accordingly, Congress mandated normalization treatment, which requires that  
4 federal income tax expense be calculated for ratemaking purposes as though the  
5 utility had depreciated its assets on a straight-line book basis.<sup>7</sup>

6 **Q. Did SPS recognize accelerated depreciation in the calculation of federal income**  
7 **tax expense included in the Test Year cost of service?**

8 A. No. To remain in compliance with the normalization rules, SPS calculated the  
9 federal income tax expense included in its cost of service using straight-line book  
10 depreciation.

11 **Q. Is a regulatory commission required by law to follow the normalization rules for**  
12 **ratemaking purposes?**

13 A. No. Congress did not directly prohibit regulators from using other methods to set  
14 rates, but if a utility were to receive a regulatory order that led to a violation of the  
15 normalization rules, both the utility and its customers would be adversely affected.  
16 When a normalization violation occurs, the utility is no longer allowed to use  
17 accelerated depreciation.<sup>8</sup> In addition, the taxes that have been deferred as a result of  
18 the prior accelerated depreciation must be paid to the federal government more

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<sup>7</sup> *Pub. Util. Comm'n v. GTE-SW*, 833 S.W.2d 153, 166 (Tex. App.—Austin 1992) (explaining normalization as follows: “[T]he expense is determined on a straight-line basis for rate-calculation purposes even though the utility determines the expense on an accelerated basis in calculating its actual income-tax liability.”), *rev’d in part on other grounds*, 901 S.W.2d 401 (Tex. 1995).

<sup>8</sup> IRC § 168(f)(2); *see also Application of Lone Star Transmission, LLC for Authority to Establish Interim and Final Rates and Tariffs*, Docket No. 40020, Order on Rehearing at Conclusion of Law No. 16 (Feb. 12, 2013) (“A violation of the normalization rules would prevent Lone Star from using accelerated tax depreciation on all of its public utility property.”).

1 quickly than they would be in the absence of the normalization violation. In light of  
2 the potential loss of accelerated deductions and for other reasons, Texas and virtually  
3 all other jurisdictions have adopted the normalization method of tax accounting for  
4 rate setting purposes.

5 **Q. How would those penalties affect the utility's customers?**

6 A. As explained in more detail below, both of those circumstances would reduce the  
7 ADIT balance, which would increase the rate base on which customers pay a return.  
8 Thus, a normalization violation would likely result in significantly higher rates for  
9 utility customers.

10 **Q. What is your recommendation with respect to how the Commission should**  
11 **calculate SPS's income tax expense?**

12 A. Based on the normalization requirements and the adverse consequences that would  
13 result if those requirements are not followed, I recommend that the Commission  
14 calculate SPS's income tax expense as though SPS had depreciated its assets on a  
15 straight-line book basis.

16 **B. Net Operating Losses and Normalization**

17 **Q. What is an NOL?**

18 A. An NOL occurs when a company's allowable tax deductions exceed its taxable  
19 income, resulting in negative taxable income. One way in which an NOL can arise is  
20 through accelerated depreciation. As previously mentioned, the use of accelerated  
21 depreciation with normalization rules generally creates a deferred tax liability. And  
22 if a utility has negative taxable income as a result of using accelerated depreciation,  
23 the utility will also have an NOL. An NOL may be carried forward to reduce taxable

1 income in future periods. For financial reporting purposes, an NOL carryforward is  
2 recorded as a deferred tax asset. In effect, an NOL represents the tax value of  
3 claimed deductions that did not reduce the current tax liability.

4 **Q. You testified earlier that SPS had an NOL carryforward from prior years.**  
5 **Please explain how that NOL arose.**

6 A. The NOL calculated for tax purposes arose because SPS claimed accelerated  
7 depreciation expense, including bonus depreciation, over the last several years. The  
8 amount of accelerated depreciation expense exceeded the amount of SPS's taxable  
9 income in those years. That excess amount represents the NOL carryforward.

10 **Q. Please explain what you mean by "bonus" depreciation.**

11 A. Bonus federal income tax depreciation is a form of accelerated depreciation that  
12 provides an additional tax incentive for investment by increasing the amount of  
13 depreciation in the first year that a depreciable asset is placed in service beyond the  
14 accelerated depreciation that would normally be available.

15 **Q. For purposes of calculating the ADIT balance for ratemaking purposes, does it**  
16 **matter whether the utility has an NOL?**

17 A. Yes. As previously explained, the ADIT balance reflects a temporary timing  
18 difference that occurs only when the utility has the ability to defer taxes that would  
19 otherwise be payable to the IRS and corresponding state agencies. If the utility is not  
20 deferring any tax liability, there is nothing to add to the ADIT balance.

21 For financial reporting purposes, SPS adjusts the ADIT balance for the full  
22 amount of accelerated depreciation claimed. If some of the deduction led to an NOL,  
23 however, SPS records a deferred tax asset that reflects the NOL carryforward. If

1 SPS did not record this deferred tax asset, the ADIT balance would overstate the  
2 amount of benefit SPS has actually realized. Therefore, when the full amount of  
3 ADIT balance is used to reduce rate base, an adjustment is needed to ensure that rate  
4 base is reduced only to the extent the utility was able to defer tax liability. Such an  
5 adjustment allows the utility to remain in compliance with the normalization rules.  
6 This adjustment is accomplished by offsetting the amount of the NOL carryforward  
7 against the ADIT balance. The resulting number represents the amount of benefit the  
8 utility has actually realized.

9 **Q. Do the Treasury normalization rules govern the treatment of deferred tax assets**  
10 **such as NOL carryforwards?**

11 A. Yes. The IRS has long held that the tax value of an NOL carryforward is a deferred  
12 tax asset that must be offset against the ADIT balance to avoid a normalization  
13 violation. Recently, the IRS reaffirmed its position in some PLRs. In PLR  
14 201438003, for example, the IRS stated that the “reduction of Taxpayer’s rate base  
15 by the full amount of its ADIT account balance unreduced by the balance of its NOL  
16 carryforward-related account balance would be inconsistent with the requirements  
17 of” IRC § 168(i)(9) and Treasury Regulation § 1.167(l). A copy of that PLR is  
18 attached to my testimony as Attachment NK-RR-2. Other PLRs to that same effect  
19 are attached to my testimony as Attachments NK-RR-3 and NK-RR-4.

20 **Q. Did SPS recognize its NOLs and apply the corresponding normalization method**  
21 **of accounting in its Updated Test Year ADIT balance calculation?**

22 A. Yes. Mr. Freitas explains that use of the NOL carryforward is reflected in SPS’s  
23 Texas retail jurisdiction cost of service for the Test Year and Updated Test Year.

1 Mr. Freitas also explains that SPS's proposed revenue requirement includes both the  
2 current income tax expense and the deferred income tax expense to reflect the  
3 depreciation allowance under straight-line book depreciation. SPS's ADIT balance,  
4 net of its NOL carryforward, is applied as a reduction to rate base for SPS's Test  
5 Year.

6 **Q. What are your recommendations with respect to how the Commission should**  
7 **calculate SPS's Test Year ADIT balance?**

8 A. I recommend that the Commission offset the tax value of SPS's NOL carryforward  
9 against SPS's ADIT Test Year balance, per IRS guidance.

1                               **VI.     EFFECTS OF RECENT TAX LEGISLATION**

2     **Q.     What topics do you discuss in this section of your testimony?**

3     A.     I discuss the effects of the Consolidated Appropriations Act, 2016, also known as the  
4             Protecting Americans from Tax Hikes Act (“PATH Act”).

5     **Q.     What effect does the PATH Act have on this case?**

6     A.     The PATH Act temporarily extended bonus depreciation and certain federal  
7             investment and production tax credits, and it permanently extended the federal R&E  
8             credit.

9     **Q.     Will you please elaborate on the PATH Act’s effect on “bonus depreciation”?**

10    A.     The PATH Act extended bonus depreciation for property placed in service during  
11            2015 through 2019. Under the PATH Act, the bonus depreciation percentage is 50%  
12            for property placed in service during 2015, 2016, and 2017, and it phases down after  
13            that to 40% in 2018 and 30% in 2019. Some longer production period property  
14            placed in service in 2020 will also be eligible for bonus depreciation.

15    **Q.     Does the cost of service reflect the use of bonus depreciation?**

16    A.     Yes. Please refer to the testimonies of Mr. Freitas and Ms. Ostrom for calculations  
17            and support of those amounts.

18    **Q.     What is the federal R&E credit?**

19    A.     The federal R&E credit is a credit available to taxpayers who engage in qualifying  
20            R&E activities. SPS completes an annual study to determine which costs are eligible  
21            for the federal R&E credit. These costs include certain wages, supplies, and contract  
22            research expenses. The credit is non-refundable, which means that a taxpayer must  
23            have a tax liability to use the credit. When there is insufficient tax liability to fully

1 use the credit, the credit may either be carried back one year or carried forward up to  
2 twenty years.

3 **Q. Did SPS include a federal R&E credit in its Test Year cost of service?**

4 A. Yes. The Updated Test Year cost of service includes \$1,726,197 (total company) of  
5 federal R&E credit.

6 **Q. How was this federal R&E credit calculated?**

7 A. The \$1,726,197 (total company) R&E credit is the actual federal R&E credit  
8 recorded in SPS's ledger from July 2016 through June 2017. This amount consists  
9 of: \$845,092 for a 2015 credit true-up recorded in September 2016; \$575,466 of  
10 estimated 2016 credit recorded from July 2016 to December 2016; and \$305,639 of  
11 estimated 2017 credit recorded from January 2017 to June 2017. To the extent the  
12 information is available, the requested R&E amount will be updated for the Update  
13 Period.

14 **Table NK-RR-2**

Updated Test Year Estimate - Federal R&E Credit	
	SPS Total Company
2015 estimated federal R&E credit (true-up accrued after return filed September 2016)	\$ 845,092
2016 estimated federal R&E credit (July-Dec 2016) estimate per 3 year average	\$ 575,466
2017 estimated federal R&E credit (Jan-Jun 2017)	\$ 305,639
Total R&E Credit included in Update Test Year	\$ 1,726,197

15  
16 **Q. What are the federal investment and production tax credits ("PTCs") that were**  
17 **extended?**

18 A. The PATH Act extended investment tax credits and PTCs referenced in IRC §48(a)  
19 and §45(d), respectively. These credits are available to taxpayers who make  
20 investments in renewable energy property such as wind farms, geothermal and solar  
21 energy generation facilities, and hydropower facilities.



1   **Q.     Did SPS include any federal investment tax credits or PTCs in its cost of**  
2       **service?**

3   **A.     No. SPS did not make qualified investments in renewable energy property during**  
4       **the Test Year or Updated Test Year, and, therefore, it does not qualify for the credits.**

1 **VII. PROPERTY TAXES**

2 **Q. Does SPS incur property taxes?**

3 A. Yes. SPS incurs property taxes in each taxing jurisdiction in which it has tangible  
4 assets, including production plant, transmission plant, distribution plant, and general  
5 plant. SPS has tangible assets in Texas, New Mexico, Oklahoma, and Kansas.

6 **Q. How did SPS calculate the property tax amounts for the Test Year?**

7 A. SPS started with the property tax amounts accrued in each month for the last nine  
8 months of 2016. SPS calculated those amounts using the 2016 tax rates for property  
9 located in Kansas and Oklahoma and 2015 tax rates for property located in Texas  
10 and New Mexico and the 2016 property tax valuations, which were based on  
11 December 31, 2015 plant assets. SPS then added to that the amounts accrued for  
12 each of the first three months of 2017, which were calculated using the 2016 tax rates  
13 for Kansas and Oklahoma and 2015 tax rates for Texas and New Mexico and plant  
14 assets as of December 31, 2016.

15 **Q. What was SPS's per book amount of property taxes for the Test Year?**

16 A. SPS's per book property taxes during the Test Year were \$38,651,047 (total  
17 company), as shown on Attachment NK-RR-5, page 2. That amount includes the  
18 adjustment to account for property tax that must be capitalized.<sup>9</sup>

19 **Q. How did SPS calculate the Updated Test Year amount of property taxes?**

20 A. SPS calculated the per book amount of property taxes for the Updated Test Year  
21 using the same method that it used to calculate the Test Year amount. In other

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<sup>9</sup> The capitalized amount associated with the Test Year property tax calculation is \$1,033,219.

1 words, SPS started with the property tax amounts accrued in each month for the last  
2 six months of 2016. SPS calculated those amounts using the 2016 tax rates and the  
3 2016 property tax valuations, which were based on December 31, 2015 plant assets.  
4 SPS then added to that the amounts accrued for each of the first six months of 2017,  
5 which were calculated using the 2016 tax rates and plant assets as of December 31,  
6 2016.

7 **Q. What was SPS's per book amount of property taxes for the Updated Test Year?**

8 A. The Updated Test Year per book property tax amount is \$40,212,107 (total  
9 company), as shown on Attachment NK-RR-5, page 3. That amount includes the  
10 adjustment to account for property tax that must be capitalized.<sup>10</sup>

11 **Q. Is SPS proposing any other adjustments to the amount of property taxes for**  
12 **purposes of this rate case?**

13 A. Yes. SPS proposes to use 2016 tax rates to calculate property taxes on the 2016  
14 year-end plant balances as the basis for its request in this case.

15 **Q. What is the amount of property tax expense using 2016 tax rates?**

16 A. Applying the 2016 tax rates to the plant-in-service balance at December 31, 2016  
17 increases property tax expense to \$43,600,000 on a total company basis, as shown on  
18 Attachment NK-RR-5, page 1.

19 **Q. Has SPS made any adjustments to property tax expense related to CWIP?**

20 A. Yes. To reflect the Commission's ruling in Docket No. 43695 that property taxes on  
21 plant that has not yet been placed in service be capitalized, SPS will remove

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<sup>10</sup> The capitalized amount associated with the Updated Test Year property tax calculation is \$1,209,088.

1           \$703,474 (total company) of property tax associated with CWIP from total property  
2           taxes. That adjustment results in a net property tax amount of \$42,896,526 (total  
3           company), which is the amount that Mr. Freitas has included in the cost of service.

4   **Q.   Has SPS included the capitalized property tax associated with CWIP in rate**  
5       **base?**

6   A.   Yes. It is my understanding that Mr. Freitas included the capitalized property tax  
7       amount in rate base.

8   **Q.   Does this conclude your pre-filed direct testimony?**

9   A.   Yes.

**AFFIDAVIT**

STATE OF MINNESOTA     )  
  )  
COUNTY OF HENNEPIN    )

NAOMI KOCH, first being sworn on her oath, states:

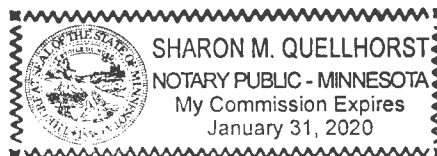
I am the witness identified in the preceding testimony. I have read the testimony and the accompanying attachment(s) and am familiar with the contents. Based upon my personal knowledge, the facts stated in the testimony are true. In addition, in my judgment and based upon my professional experience, the opinions and conclusions stated in the testimony are true, valid, and accurate.

Naomi Kh     8-7-2017  
NAOMI KOCH

Subscribed and sworn to before me this 7<sup>th</sup> day of August, 2017 by NAOMI KOCH.

Sharon M. Quellhorst  
Notary Public, State of Minnesota

My Commission Expires: 1/31/2020



**Southwestern Public Service Company**

**Internal Revenue Code § 168 and 26 C.F.R.**

**§ 1.167**

**2017 TX Rate Case**

**APPLICATION OF  
SOUTHWESTERN PUBLIC SERVICE COMPANY  
FOR AUTHORITY TO CHANGE RATES**

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**NK-RR-1(V)**

**Internal Revenue Service**Number: **201438003**

Release Date: 9/19/2014

Index Number: 167.22-01

**Department of the Treasury**

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B06

PLR-104157-14

Date:

June 12, 2014

**LEGEND:**

Taxpayer =

Parent =

State A =

Commission A =

Commission B =

Year A =

Year B =

Year C =

Year D =

Date A =

Date B =

Date C =

Date D =

Case =

Director =

Dear :

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.

PLR-104157-14

2

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



PLR-104157-14

3

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.

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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

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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

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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.

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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:

**Internal Revenue Service**Number: **201436038**

Release Date: 9/5/2014

Index Number: 167.22-01

**Department of the Treasury**

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B06

PLR-148311-13

Date:

May 22, 2014

**LEGEND:**

Taxpayer =

Parent =

State A =

State B =

State C =

Commission A =

Commission B =

Commission C =

Year A =

Year B =

Date A =

Date B =

Date C =

Date D =

Date E =

Case =

Director =

Dear . :

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.



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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

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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



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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

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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.

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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.

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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:

**Internal Revenue Service**Number: **201436037**

Release Date: 9/5/2014

Index Number: 167.22-01

**Department of the Treasury**

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B06

PLR-148310-13

Date:

May 22, 2014

**LEGEND:**

Taxpayer =

Parent =

State A =

State B =

State C =

Commission A =

Commission B =

Commission C =

Year A =

Year B =

Date A =

Date B =

Date C =

Case =

Director =

Dear :

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.

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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.

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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



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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



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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

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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.

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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:

## Southwestern Public Service Company

### Property Tax Calculation

#### Line

#### No. Description

1	TX Property Tax Accrued (2017)	\$ 33,600,000	(1)
2	NM Property Tax Accrued (2017)	8,400,000	(1)
3	KS Property Tax (2017)	1,000,000	(1)
4	OK Property Tax (2017)	600,000	(1)
5	Total SPS Property Tax - Tax Year 2017	43,600,000	
6	Property Tax Capitalized - CWIP Adjustment	(703,474)	(2)
7	Recommended Property Tax Expense	\$ 42,896,526	

<sup>(1)</sup> Estimated 2017 property tax per books based on 12/31/2016 plant balances and 2016 tax rates.

<sup>(2)</sup> Please see page 4 of this attachment for the detailed calculation.

Southwestern Public Service Company

Property Tax Calculation

Per Book Property Tax - Historical Test Year

Line No.		Texas	New Mexico	Expense Booked Kansas	Oklahoma	Total
1	Apr-16	\$ 2,682,330.00	\$ 575,000.00	\$ 75,000.00	\$ 50,000.00	\$ 3,382,330.00
2	May-16	2,682,330.00	575,000.00	75,000.00	50,000.00	3,382,330.00
3	May-16 **	404,627.29	-	-	-	404,627.29
4	May-16 *	-	(96,439.48)	-	-	(96,439.48)
5	Jun-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
6	Jun-16 ***	(791,700.00)	-	-	(41,700.00)	(833,400.00)
7	Jul-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
8	Aug-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
9	Sep-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
10	Oct-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
11	Nov-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
12	Dec-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
13	Dec-16 ***	50.00	-	(18,471.40)	56,560.00	38,138.60
14	Dec-16 #	(596,150.68)	(261,200.00)	-	-	(857,350.68)
15	Jan-17	2,799,000.00	700,000.00	83,330.00	50,000.00	3,632,330.00
16	Feb-17	2,799,000.00	700,000.00	83,330.00	50,000.00	3,632,330.00
17	Mar-17	2,799,000.00	700,000.00	83,330.00	50,000.00	3,632,330.00
18	Mar-17 ##	(76,585.46)	(99,283.00)	-	-	(175,868.46)
19	<b>TOTAL</b>	<b>\$ 30,369,901.15</b>	<b>\$ 6,818,077.52</b>	<b>\$ 906,518.60</b>	<b>\$ 556,550.00</b>	<b>\$ 38,651,047.27</b>

\* Tax year 2014 true-up

\*\* Tax year 2015 true-up

\*\*\* Tax year 2016 true-up

# 2016 Property Tax on CWIP Capitalized

## 2017 Q1 Property Tax on CWIP Capitalized

Southwestern Public Service Company

Property Tax Calculation

Adjusted Property Tax - Updated Test Year

Line No.		Texas	New Mexico	Expense Booked Kansas	Oklahoma	Total
1	Jul-16	\$ 2,524,000.00	\$ 575,000.00	\$ 75,000.00	\$ 41,670.00	\$ 3,215,670.00
2	Aug-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
3	Sep-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
4	Oct-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
5	Nov-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
6	Dec-16	2,524,000.00	575,000.00	75,000.00	41,670.00	3,215,670.00
7	Dec-16 **	50.00	-	(18,471.40)	56,560.00	38,138.60
8	Dec-16 #	(596,150.68)	(261,200.00)	-	-	(857,350.68)
9	Jan-17	2,799,000.00	700,000.00	83,330.00	50,000.00	3,632,330.00
10	Feb-17	2,799,000.00	700,000.00	83,330.00	50,000.00	3,632,330.00
11	Mar-17	2,799,000.00	700,000.00	83,330.00	50,000.00	3,632,330.00
12	Mar-17 ##	(76,585.46)	(99,283.00)	-	-	(175,868.46)
13	Apr-17	2,799,000.00	700,000.00	83,330.00	50,000.00	3,632,330.00
14	May-17	2,799,000.00	700,000.00	83,330.00	50,000.00	3,632,330.00
15	May-17 **	(103,878.08)	435,412.43	-	-	331,534.35
16	May-17 *	-	(36,478.83)	-	-	(36,478.83)
17	Jun-17	2,799,000.00	700,000.00	83,330.00	50,000.00	3,632,330.00
18	Jun-17 ##	(76,585.46)	(99,283.00)	-	-	(175,868.46)
19	<b>TOTAL</b>	<b>\$ 31,084,850.32</b>	<b>\$ 7,589,167.60</b>	<b>\$ 931,508.60</b>	<b>\$ 606,580.00</b>	<b>\$ 40,212,106.52</b>

\* Tax year 2015 true-up

\*\* Tax year 2016 true-up

# 2016 Property Tax on CWIP Capitalized

## 2017 Property Tax on CWIP Capitalized

(1) Please see page 3 of this attachment for the detailed calculation.  
\$703,474 divided by 4 = quarterly adjustment of \$175,868

**Southwestern Public Service Company**

**Property Tax Calculation  
with Capitalized CWIP**

Line No.		Property Tax Accrual Year End 12/30/17
1	TX Property Tax Accrued (2017)	\$ 33,600,000
2	NM Property Tax Accrued (2017)	8,400,000
3	KS Property Tax Accrued (2017)	1,000,000
4	OK Property Tax Accrued (2017)	600,000
5	Total 2016 NSPM Property Tax	43,600,000
6	Less: Allocable to CWIP FERC Acct 107	(703,474)
7	Total Less CWIP Property Tax	\$ 42,896,526
8	Utility Plant at 12/30/2016	6,647,684,550
9	Less CWIP	(260,327,432)
10	Net Plant Balance	6,387,357,118
11	Calendar Year (2017) Estimated ETR	0.0067158
12	CWIP Subject to Tax	\$ 107,257,765
13	As a percentage of Total Plant	0.016135
14	Property Tax allocable to CWIP	\$ 703,474
15	Texas	\$ 306,336.24
16	New Mexico	397,138
17	Kansas	-
18	Oklahoma	-
19	CWIP Subject to Tax	\$ 703,474
20		
21	CWIP in TX	\$ 46,706,703 \$ 138,817,684
22	CWIP in NM	60,551,062 121,102,123
23	CWIP in KS	- 242,693 <sup>(1)</sup>
24	CWIP in OK	- 164,931 <sup>(1)</sup>
25	CWIP Balances	\$ 107,257,765 \$ 260,327,432

<sup>(1)</sup> Estimated impact of KS and OK passed on for accounting purposes due to immateriality .