BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET UE-240006

DOCKET UG-240007

EXH. EMA-4

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REPRESENTING AVISTA CORPORATION

AVISTA

Interoffice Memorandum

Tax Department

DATE: April 8, 2022

TO: File

FROM: Dan Loutzenhiser, Director of Tax

Subject: Normalization Requirements affected by COR

Issue:

How will Avista account for the inclusion of cost of removal ("COR") within its excess deferred income taxes ("EDIT") to avoid normalization violations as proscribed by the Internal Revenue Service outlined in a series of private letter rulings?

Conclusion:

Avista's EDIT have been returned to customers faster than the Average Rate Assumption Method ("ARAM") should allow due to COR being included in book depreciation expense. To correct this inadvertent normalization violation, Avista must change how it calculates the reversal of EDIT. Based on all facts and circumstances, Avista is unable to cost effectively calculate ARAM with its current systems and will use an alternative method, referred to as the Reverse South Georgia Method ("RSGM"), effective January 1, 2022.

Facts and Analysis:

Background:

In 2017, the Tax Cuts and Jobs Act ("TCJA") was enacted changing the corporate tax rate from 35% to 21%. Avista remeasured its deferred tax assets and liabilities to the new tax rate resulting in the creation of EDIT on the 14% rate differential. The plant related EDIT totaled approximately $316 million as of December 31, 2017. The Company has started to reverse the plant EDIT balance over the past 4 years using ARAM as calculated in PowerTax. Under ARAM, excess deferreds begin reversing when book depreciation is greater than tax depreciation on a tax class and vintage basis.

For regulatory reporting, Avista accounts for its annual depreciation expense based on book depreciation, estimated COR, and salvage. COR is, therefore, a component of establishing the applicable composite depreciation rate and is collected from customers over the estimated book life of the asset.

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For tax purposes, actual COR is deductible when incurred. Avista reports its customer collections that fund the COR reserve as taxable income over the operating life of an asset, claiming an offsetting tax deduction at the end of the asset life upon retirement if applicable. This COR book/tax difference creates a deferred tax asset ("DTA"). The COR-related DTA is included in Avista's overall plant related accumulated deferred federal income taxes ("ADFIT") in FERC Account 282900. Similarly, the COR-related EDIT is netted against other plant-related EDIT balances within PowerTax, including those derived from tax method and life differences. The EDIT amount related specifically to COR is unknown as PowerTax is not set up to track this DTA separately from the method/life plant deferred tax liability ("DTL").

Tax Law & Analysis:

TCJA Section 13001(d)(1) provides that a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of § 167 or § 168 if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under ARAM.

Recently the Internal Revenue Service (IRS) has issued multiple private letter rulings (PLR) addressing the treatment of COR as it pertains to normalization and ARAM. In PLR 202141001 the IRS held that accrued gross COR included within the book depreciation expense and the subsequent tax deduction were not subject to normalization rules as set forth under IRC Section 168(i)(9). Similarly, the associated EDIT attributable to COR is not subject to normalization rules under TCJA Section 13001(d).

In addition, the computation of the reversal of protected EDIT (i.e. depreciation method/life related EDIT) based on book depreciation amounts inclusive of COR pursuant to the State Commission Method is not consistent with the normalization rules of TCJA Section 13001(d). See attached example illustrating the impacts to ARAM when COR is included in book depreciation:

Note: Under PLR 202141001 the timing differences between recognition of accrued gross salvage value as a reduction of depreciation expense and the subsequent taxation of such salvage amounts upon disposition is subject to the normalization rules of IRC Section 168(i)(9) and the associated excess deferred tax amount is subject to the normalization rules of TCJA Section 13001(d) regardless of any COR offsets.

The IRS has created Revenue Procedure 2017-47 to provide a safe harbor for inadvertent or unintentional normalization violations. To qualify for this relief, the taxpayer must change its inconsistent practice to a consistent practice approved by the utility regulator at its next available opportunity.

IRS Revenue Procedure 2020-39, Section 4.01 provides that under Section 1300a(d)(1) of the TCJA, taxpayers must use ARAM to calculate the reversal of EDIT if the taxpayer's regulatory books are based upon the vintage account data necessary to use ARAM. However, if the taxpayer's regulatory books are not based upon the vintage account data that is necessary for ARAM, use of an alternative method is allowed. Section 4.02 provides that the determination of

whether a taxpayer's regulatory books contain sufficient vintage account data necessary to use ARAM is determined based on all the facts and circumstances. The use of the RSGM as an alternative method is generally accepted. RSGM means a method whereby a taxpayer computes the EDIT on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes and reduces the EDIT ratably over the remaining regulatory life of the property.

Considerations & Application:

Avista currently includes COR as a component of book depreciation for purposes of calculating ARAM, resulting in EDIT reversing faster than allowed. PowerTax is not set up to track the COR DTA separately from the overall plant method/life DTL. Upon analysis, the Company has determined it would be administratively burdensome to reconfigure its fixed asset software to track COR separately for all vintages and has identified three options to avoid an inadvertent normalization violation.

Option 1 - Avista could hire consultants well versed in PowerTax to reconfigure the software and separate all COR balances retrospectively. This option would be time consuming and costly.

Option 2 - Avista could adopt a hybrid method by leaving historical balances the same but remove COR amounts from book depreciation on a prospective basis. This would ensure that book COR would not generate a faster reversal of EDIT than allowed but would not accurately portray COR DTA balances.

Option 3 - Avista could adopt RSGM, an acceptable alternative method for reversing EDIT, instead of using ARAM.

After analyzing the pros and cons of each option, the Company has chosen Option 3 to best balance the accuracy, cost, and administrative burden of complying with the IRS regulations. RSGM is allowed since the Company uses composite rates and does not have the vintage information necessary to accurately calculate ARAM without COR.

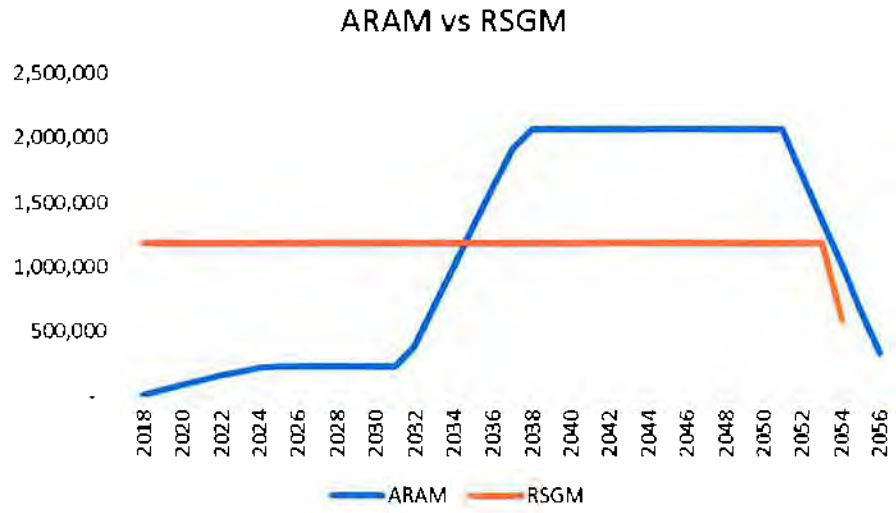
Under the RSGM, the Company is calculating the estimated remaining book life by dividing depreciation expense by the net book value. This is calculated by book allocation group to correspond to deferred tax mapping in PowerTax. Depreciation is based on the 2016 depreciation study and will be updated when depreciation studies are completed in the future. The estimated 12/31/2021 excess deferred balance by book allocation group is divided by the estimated remaining book life to create a straight-lined amortization of the EDIT balance.

Accounting Impacts:

The following table summarizes the change between the EDIT reversal over ARAM versus RSGM.

	ARAM Forecast	RSGM Estimate	Change
2022	10,948,563.98	11,761,956.49	813,392.51
2023	10,950,863.93	11,744,576.32	793,712.39
2024	9,845,983.71	11,744,576.32	1,898,592.61
2025	8,730,467.77	11,744,576.32	3,014,108.55
2026	8,465,625.88	10,476,602.16	2,010,976.28

As shown, the excess deferred reversal will increase initially under RSGM due to the straight-line nature of the calculation. The ARAM calculation is a bell curve with amounts increasing initially over time as more vintages experience an excess of book depreciation over tax depreciation. **Note**: The table above is showing the ARAM amounts decreasing over time which is the result of shorter-lived assets such as software and computer equipment becoming fully depreciated. The graph below illustrates the different methods based on an asset with a 20-year remaining book life.



Rate Impacts:

To comply with Rev. Proc. 2017-47, Avista must include the RSGM EDIT reversal amount in customer rates at the next available opportunity. The Company is currently in general rate case ("GRC") proceedings in Washington and will make the necessary changes to follow the normalization rules set forth. Avista is also working through how to be compliant in Idaho and Oregon without a GRC proceeding currently active.

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ARAM Example

		Year 1	Year 2	Year 9	Year 10	Total	TCJA	EDIT		EDIT Reversal Year 11	EDIT Reversal Year 12	EDIT Reversal Year 13
Book Depr		200,000,000	200,000,000	200,000,000	200,000,000	2,000,000,000						
COR		40,000,000	40,000,000	40,000,000	40,000,000	400,000,000						
Total		240,000,000	240,000,000	240,000,000	240,000,000	2,400,000,000						
									Protected %	83%	83%	83%
Tax Depr		300,000,000	300,000,000	300,000,000	300,000,000	3,000,000,000			**Non (COR) %**	COR EDIT reversal % determined when assets retired		
Diff w/COR		(60,000,000)	(60,000,000)	(60,000,000)	(60,000,000)	(600,000,000)	(600,000,000)		**Reversal Est %**	7%	8%	9%
	35%	35%	35%	35%	35%		21%					
DFIT		(21,000,000)	(21,000,000)	(21,000,000)	(21,000,000)	**(210,000,000)**	**(126,000,000)**	**(84,000,000)**	**Combined**	(5,880,000)	(6,720,000)	(7,560,000)
Diff w/o COR		(100,000,000)	(100,000,000)	(100,000,000)	(100,000,000)	(1,000,000,000)	(1,000,000,000)			Normalization violation issue is that we are giving back		
	35%	35%	35%	35%	35%		21%			EDIT faster than what we should		
DFIT w/o COR		(35,000,000)	(35,000,000)	(35,000,000)	(35,000,000)	(350,000,000)	(210,000,000)	**(140,000,000)**	**Protected**	(4,900,000)	(5,600,000)	(6,300,000)
COR Stand Alone		14,000,000	14,000,000	14,000,000	14,000,000	140,000,000	84,000,000	**56,000,000**	**Non-protected (COR)**	COR EDIT reversal when assets retired		

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