

Exhibit No. \_\_\_\_ (KHB-1T)  
Docket UE-100749  
Witness: Kathryn H. Breda

**BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION,**

**Complainant,**

**v.**

**PACIFICORP D/B/A PACIFIC POWER  
& LIGHT COMPANY,**

**Respondent.**

**DOCKET UE-100749**

**TESTIMONY OF**

**Kathryn H. Breda**

**STAFF OF  
WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION**

*Federal Tax Issues*

**October 5, 2010**

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Exhibit No. \_\_\_ (KHB-4) PacifiCorp Response to Staff Data Request 148

1 I. INTRODUCTION

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

4 A. My name is Kathryn H. Breda. My business address is The Richard Hemstad  
5 Building, 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA  
6 98504. My email address is kbreda@utc.wa.gov.

7  
8 **Q. By whom are you employed and in what capacity?**

9 A. I am employed by the Washington Utilities and Transportation Commission as  
10 (“Commission”) as a Regulatory Analyst.

11  
12 **Q. How long have you been employed by the Commission?**

13 A. I have been employed by the Commission since 2008.

14  
15 **Q. Would you please state your educational and professional background?**

16 A. I graduated from the University of Washington in 1980 receiving a Bachelor of Arts  
17 in Business Administration with a major in Accounting. I am a licensed Certified  
18 Public Accountant in the State of Washington.

19 My responsibilities at the Commission generally comprise financial,  
20 accounting and other analyses in general rate cases, accounting petitions, other tariff  
21 filings, and compliance filings. I testified in Docket UE-090704 and participated in  
22 Staff’s review of Dockets UE-100467/UG-100468, UE-090134/UG-090134, UE-  
23 090205, UE-080220 and UG-080546.

1 Prior to my employment with the Commission, I held various corporate  
2 accounting and regulatory management positions including tax accounting from  
3 1980 through 2000 with Qwest Communication in Seattle and Pacific Gas and  
4 Electric Company in San Francisco.

5  
6 **II. SCOPE AND SUMMARY OF TESTIMONY**

7  
8 **Q. What is scope of your testimony?**

9 A. The scope of my testimony is to address the federal tax issues presented by Pacific  
10 Power & Light Company (“PacifiCorp” or “Company”) in this case.

11  
12 **Q. Please summarize your recommendations.**

13 A. Based on my analysis, I recommend the Commission:

- 14 1. Reject both the Company’s proposals to:
- 15 a. Adopt full normalization of federal income tax, and,
- 16 b. Create a reserve for interest related to the Company’s decision to
- 17 make a tax change for the recognition of repair expenditures for tax
- 18 years 1999 and forward, referred to as the “repairs deduction”.
- 19 2. Accept the Company’s proposal to normalize the repairs deduction included
- 20 in the Company’s 2008 Federal Income Tax Return, and
- 21 3. Accept two proposed Staff Adjustments related to items 1 and 2:
- 22 a. Removal of Adjustment 7.9, Current Year Deferred Income Tax
- 23 Normalization. This adjustment eliminates the Company’s

1 adjustment to remove flow-through tax recognition for the current  
2 year.

3 b. Staff Adjustment 8.11, Repairs Deduction. This restating adjustment  
4 reflects the restatement of the Repairs Deduction, recorded in  
5 September 2009, reflecting an entire year effect of the 2008 federal  
6 income tax return adjustment.

7  
8 **Q. Please identify the revenue requirement impacts of your recommendations.**

9 A. My removal of Company Adjustment 7.9, Current Year Deferred Income Tax  
10 removes the current year impact of the Company's proposal to adopt normalization  
11 starting January 1, 2011. This adjustment increases net operating income by  
12 \$525,562, increases the net rate base by \$262,718, and decreases overall revenue  
13 requirement by \$816,135. These are Washington figures. My Exhibit No. \_\_\_\_  
14 (KHB-2) contains these figures.

15 My Adjustment 8.11, Repairs Deduction, includes the annual effect of the  
16 repairs deduction in Accumulated Deferred Income Tax. This restating adjustment  
17 decreases Net Rate Base by \$14,463,670 and decreases overall revenue requirement  
18 by \$1,745,310. These are Washington figures. My Exhibit No. \_\_\_\_ (KHB-3)  
19 contains the calculation of these figures.

20

1 III. NORMALIZATION VERSUS FLOW-THROUGH

2  
3 A. Background

4  
5 Q. Please describe the normalization and flow-through methods of accounting for  
6 federal income taxes for ratemaking purposes.

7 A. Federal income tax law allows a public utility company to recognize income or  
8 expense in time periods different from the time period the utility recognizes those  
9 items on its accounting records.<sup>1</sup> These timing differences create deferred taxes.

10 Income taxes reflected on the utility's income statement are based on the  
11 federal statutory tax rate. The difference between what taxes are currently payable  
12 and the total taxes, based on the statutory rate, determines the amount of deferred  
13 tax.

14 The flow-through method of accounting for income taxes uses the current  
15 taxes payable to determine tax expense for ratemaking purposes. The utility realizes  
16 tax benefits included in actual taxes payable in the current period, similar to the cash  
17 basis of accounting.

18 By contrast, tax expense, under normalization, reflects current taxes payable  
19 plus deferred taxes, similar to the accrual basis of accounting. Therefore, the  
20 presumption, in some cases, can be made that the normalization method of  
21 accounting for income taxes upholds the matching principle and provides  
22 intergenerational equity. It is important to note that the amount of income tax

---

<sup>1</sup> A public utility's accounting records, or book income, are based on Generally Accepted Accounting Principles ("GAAP").

1 expense is the same over the life of the asset under both the flow-through and  
2 normalization methods.

3  
4 **Q. Please explain the position in favor of flow-through accounting for income**  
5 **taxes.**

6 A. An argument for flow-through accounting assumes that the regulated utility's taxes  
7 payable, or taxes on a flow-through basis, will always be less than those reflected on  
8 its accounting records, or on a normalized basis (taxes payable plus deferred taxes).  
9 This presumes the utility's business will continue to grow, and therefore, deferred  
10 taxes will continue to grow. Under this scenario, taxes payable will always be less  
11 than total taxes as reflected in the accounting records, based on the federal statutory  
12 rate, because the growth in utility investment will always be greater and therefore,  
13 the deferrals of tax will more than offset the reversals<sup>2</sup> of deferred tax.

14  
15 **Q. Please provide a brief history of normalization versus flow-through tax**  
16 **recognition for public utilities.**

17 A. The enactment of the Internal Revenue Code ("IRC") of 1954 sanctioned utilities'  
18 use of accelerated depreciation for federal income tax purposes, to stimulate capital  
19 formation and economic growth. At that time, regulators began to require public  
20 utilities to use these accelerated depreciation methods for tax purposes and to "flow  
21 through" the benefits of the associated reduced federal income tax expense to  
22 ratepayers.

---

<sup>2</sup> This refers to the assumption that tax depreciation, and therefore deferred tax, is larger than the straight-line depreciation amount in the early years of an asset's life, and it "reverses" and becomes smaller than the straight-line depreciation amount in later years.



1 By the late 1960s, this regulatory treatment became an increasing concern to  
2 Congress. The concern was that the flow-through method was causing a drain on  
3 federal tax revenues by reducing the utility's current tax liability, and the utility's  
4 gross revenue through reduced rates. To address this concern, Congress added  
5 depreciation normalization requirements to the IRC, beginning with the Tax Reform  
6 Act of 1969.<sup>3</sup> These requirements in effect "froze" the level of accelerated  
7 depreciation tax benefits flowed through to ratepayers by public utilities, because  
8 Congress prohibited flow through accounting for accelerated depreciation unless it  
9 was used before December 31, 1969.

10 In 1981, Congress extended normalization requirements to all public utility  
11 property. If a utility failed to follow normalization requirements, the utility would  
12 lose accelerated depreciation deductions for its public utility property.<sup>4</sup>

13 Consequently, regulators, such as the Commission, can now only require  
14 utilities to use the flow-through method on items that are not protected by these  
15 normalization requirements.

16  
17 **Q. How do normalization requirements affect the rate making benefits of flow-**  
18 **through accounting for income tax?**

19 **A.** As I stated earlier, regulators can still require flow-through treatment, but only for  
20 items that are not protected by the normalization requirements of the IRC. The  
21 impact of the normalization requirements lessens the overall effect of flow-through  
22 treatment, and consequently, for specific items, flow-through may cause fluctuations

---

<sup>3</sup> Former Internal Revenue Code Section 167(l) (26 U.S.C. § 167(l)).

<sup>4</sup> Treasury Regulation Section 1.167(l)-1(a)(4) (49 C.F.R. § 1.167(l) - 1(a)(4)).

1 in taxes reflected in cost of service for ratemaking purposes. I illustrate this later in  
2 my testimony when I describe the 2009 impact of the repairs deduction on a flow-  
3 through basis. Moreover, under the flow-through method, if a utility does not file  
4 annual rate cases, ratepayers could lose the rate impact of the tax benefits, or those  
5 benefits may not be recognized for ratemaking purposes. Under normalization,  
6 deferred tax benefits are preserved and reflected over the life of an asset.

7  
8 **B. Policy Considerations**

9  
10 **Q. What is the Commission's policy with respect to normalization versus the flow-**  
11 **through methods of accounting for federal income tax?**

12 A. It is my understanding the Commission's long-standing policy is to use flow-through  
13 when it is lawful to do so. For example, in Docket U-83-54, the Commission  
14 reaffirmed its use of flow-through method for accounting for income tax on those  
15 items not protected by normalization requirements, stating as follows:

16 It is the Commission's policy to flow through the benefits of deferred taxes to  
17 the ratepayers when such treatment is consistent with federal tax laws. To  
18 the extent that this principle has not been followed consistently in previous  
19 orders, let it be clearly understood that the principle has not been abandoned.<sup>5</sup>  
20

21 I did not locate any order in which the Commission changed this general policy.  
22

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<sup>5</sup> *UTC v. Puget Sound Power & Light Company, Cause U-83-54*, Fourth Supp. Order at page 36 (September 28, 1984). The Commission affirmed this position in its orders in Causes U-84-18, *UTC vs. Continental Tel. Co. of the Northwest, Inc.* Second Supp. Order at page 19 (January 15, 1985); U-85-53, *UTC vs. Puget Sound Power & Light Co.*, Second Supp. Order at page 46 (May 16, 1986); U-82-41 *UTC vs. Continental Tel. Co. of the Northwest, Inc.*, Second Supp. Order at pages 9 and 14 (August 12, 1983); and Docket UE-971619, *In re Petition of Puget Sound Energy, Inc.*, Accounting Order for the Treatment for the Purchase of a Gas Sales Contract at page 5 (December 15, 1997).

1 **Q. What is the main reason for the Commission policy preferring flow-through**  
2 **versus normalization?**

3 A. Simply put, flow-through passes the tax benefits to customers as the company  
4 receives them.

5

6 **Q. Has the Commission recognized the normalization method for accounting for**  
7 **income tax in any specific instances other than those mandated by the IRC?**

8 A. Yes. In certain instances, and on a case-by-case basis, the Commission has  
9 authorized normalization treatment on specific issues. The following list contains  
10 some examples in which the Commission has approved normalization accounting:

- 11 1. Docket UE-031658 - PacifiCorp - Environmental remediation costs
- 12 2. Docket UE-940947 - PacifiCorp – Amortization of gains from sales of  
13 Sulfur Dioxide (“SO2”) Emission Allowances
- 14 3. Docket UE-040926 - Puget Sound Energy, Inc. - Tree Watch expenditures

15

16 **C. PacifiCorp’s Full Normalization Proposal**

17

18 **Q. Please describe PacifiCorp’s full normalization proposal.**

19 A. The Company reflects its results of operations for the year 2009 on a fully  
20 normalized basis and “proposes to address the recovery of the regulatory asset for  
21 flow-through on a non-property related temporary book-tax differences in the next  
22 filed rate case, at which time the final regulatory asset or regulatory liability will

1 have been determined".<sup>6</sup> The Company also asserts normalization is beneficial  
2 because it provides a consistent policy throughout the jurisdictions in which they  
3 operate, and promotes intergenerational equity.<sup>7</sup>  
4

5 **D. Discussion**  
6

7 **Q. What are the rate making issues related to this proposal?**

8 A. First, this proposal presents a general policy issue. If the Commission adopts full  
9 normalization for PacifiCorp as a matter of policy, that policy could apply to all  
10 utilities. Because of the global nature of this issue and the potential impact on  
11 ratepayers, an analysis involving each utility would need to be completed on a case-  
12 by-case basis before the Commission could assess the overall impact of this policy  
13 change.

14 Second, the proposed change to full normalization should include a thorough  
15 analysis of the rate making impacts, both current and long term. The Company has  
16 not provided a complete analysis.  
17

18 **Q. Is consistency among jurisdictions a sufficient justification for the Commission**  
19 **to accept full normalization?**

20 A. No. Part of the opportunities and challenges of a public utility operating in multiple  
21 states is accounting for differences in rate making treatment among states. Even  
22 though a public utility may recognize a benefit from all states operating consistently,

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<sup>6</sup> Exhibit No. \_\_\_\_ (RF-1T) page 10-11, lines 19-22 and 1-2, respectively.

<sup>7</sup> Exhibit No. \_\_\_\_ (RF-1T) page 6-7, line 12-23 and 1-6, respectively.

1 this has not and arguably should not be a consideration of regulators when setting  
2 rates. GAAP provides for recognition of these differences as a known certainty for  
3 regulated public utilities.  
4

5 **Q. Did PacifiCorp provide supporting analysis to determine the complete impact,**  
6 **both current and long term, of its proposed change to full normalization?**

7 A. No. The Company proposes to apply full normalization on a prospective basis  
8 beginning January 1, 2011.<sup>8</sup> The Company did not quantify the dollar amount,  
9 supporting detail, or revenue requirement impact associated with this change.  
10 Instead, the Company suggests that they will address the recovery “in the next filed  
11 rate case at which time the final regulatory asset or liability will be determined.” It  
12 would be premature for the Commission to grant a policy change for tax recognition  
13 without a full understanding of the implications and impacts.  
14

#### 15 IV. REPAIRS DEDUCTION

##### 16 17 A. Background

18  
19 **Q. Please explain the sections of the Internal Revenue Code (“IRC”) that apply to**  
20 **determine whether a capital expenditure is either capitalized or expensed.**

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<sup>8</sup> Exhibit No. \_\_\_\_ (RF-1T), page 8, lines 17-19.

1 A. IRC section 263<sup>9</sup> governs whether fixed asset expenditures must be capitalized or are  
2 currently deductible as an expense under IRC section 162. Treasury Regulations  
3 Section 1.162-4<sup>10</sup> states:

4 The cost of incidental repairs which neither materially add to the value of the  
5 property nor appreciably prolong its life, but keep it in an ordinarily efficient  
6 operating condition, may be deducted as an expense, provided the cost of  
7 acquisition or production or the gain or loss basis of the taxpayer's plant,  
8 equipment, or other property, as the case may be, is not increased by the  
9 amount of such expenditures. Repairs in the nature of replacements, to the  
10 extent that they arrest deterioration and appreciably prolong the life of the  
11 property, shall either be capitalized and depreciated in accordance with  
12 section 167 or charged against the depreciation reserve if such an account is  
13 kept.

14  
15 **Q. Please describe PacifiCorp's change in reporting federal income tax associated**  
16 **with repair expenditures, called the "repairs deduction".**

17 A. Previously, in general, PacifiCorp was capitalizing repair expenditures for federal  
18 income tax purposes, consistent with its accounting for GAAP reporting purposes.  
19 However, on December 30, 2008, the Company filed with the Internal Revenue  
20 Service ("IRS") a Form 3115, Application for Change in Accounting Method,  
21 requesting permission to change its "method of accounting for routine repair and  
22 maintenance costs properly deductible under IRC Section 162."

23 The Company requested the consideration of certain repair expenditures as a  
24 deduction for federal income tax reporting only. These repair deductions would  
25 continue to be capitalized and depreciated for regulatory accounting and GAAP  
26 purposes. On October 2, 2009, and October 7, 2009, the IRS issued four consent

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<sup>9</sup> 26 U.S.C. § 263.

<sup>10</sup> 26 C.F.R. § 1.162-4.

1 agreements (two for generation assets and two for network assets) granting  
2 PacifiCorp the change the Company requested.<sup>11</sup>

3  
4 **B. PacifiCorp's Repairs Deduction Normalization Proposal**

5  
6 **Q. Please describe PacifiCorp's proposal regarding the Repairs Deduction.**

7 A. In its test year results of operations, PacifiCorp includes the impact of the repairs  
8 deduction on a normalized basis. However, the Company reflects only half of the  
9 entire rate base impact to accumulated deferred income tax. Company witness Ryan  
10 Fuller illustrates the impact the Company has included in the test year in his Exhibit  
11 No. \_\_\_ (RF-5). As shown in that exhibit, the Company has included a reduction of  
12 \$14,463,685 in rate base, which amounts to a reduction in revenue requirement of  
13 \$1,745,310.

14  
15 **C. Discussion**

16  
17 **Q. What was the impact of PacifiCorp's repairs deduction on a Washington basis?**

18 A. I show the impact of the repairs deduction on a Washington basis on the following  
19 table. Please note the term "protected" means the income taxes associated with the  
20 type of repairs expense at issue must be normalized. "Unprotected" means flow-  
21 through treatment is possible and not a violation of the IRC:

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<sup>11</sup> Exhibit No. \_\_\_ (RF-1T) page 2 and 3, lines 17-23 and 1-4, respectively.

1 State of Washington

Amount (1)	Revenue Requirement (2)
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2 **Flow-Through Basis:**

Current Income Tax Expense	<u>\$(18,354,888)</u>	<u>\$ (29,610,389)</u>
Accumulated Deferred Income Tax	<u>(10,572,482)</u>	<u>\$ (1,275,766)</u>
Total		<u>\$ (30,886,155)</u>

4 **Normalization:**

Protected Repairs Deduction	(10,572,482)	
Unprotected Repairs Deduction	<u>(18,354,888)</u>	
Accumulated Deferred Income Tax	<u>\$(28,927,370)</u>	<u>\$ (3,490,623)</u>

7 (1) Exhibit No. RF-5 Page 3 Protected and Unprotected repairs deduction

8 (2) Conversion Factor 0.61988

9 Rate of Return 7.48%

10 The flow-through method of accounting for income taxes recognizes a  
11 decrease in current taxes payable for the portion that is not protected by  
12 normalization rules, and an increase in accumulated deferred income tax for the  
13 protected portion.

14 This table shows the revenue requirement impact of the repairs deduction on  
15 a flow-through basis would be a decrease of \$29,611,389<sup>12</sup> related to decrease in  
16 current income tax payable, and \$1,275,766 for the increase in accumulated deferred  
17 income tax, for a total revenue requirement decrease of \$30,886,155.

18 On a normalized basis, the entire repairs deduction is reflected as an increase  
19 to accumulated deferred income tax or a decrease to the net rate base. The ratepayer  
20 receives the benefit of the return on the reduction in rate base and the Company  
receives the benefit of the reduction in cash expenditures for both the protected and

<sup>12</sup> This is the unprotected portion of \$(18,354,888) divided by the conversion factor of 0.61988 equals \$(29,610,389). The net rate base reduction of \$(10,572,482) multiplied by Staff's recommended 7.48 per cent rate of return, divided by the conversion factor of 0.61988 equals \$(1,275,766).



1 unprotected portion. The reduction in expense will be reflected over the life of the  
2 asset. The impact to the accumulated deferred income tax is an increase of  
3 28,927,370, which includes both the protected portion of \$10,572,482 plus the  
4 unprotected portion of \$18,354,888, for a total net rate base reduction of  
5 \$28,927,370, or a revenue requirement reduction of \$3,490,623.<sup>13</sup>

6  
7 **Q. Please explain the impact of removing the repairs deduction from the test year**  
8 **tax calculation.**

9 A. Reflecting the test year without the tax accounting change for repairs is not as simple  
10 as just removing the rate base impact.<sup>14</sup> To correctly reflect the removal of the  
11 repairs adjustment, taxes would have to be reflected as if the repair expenditure was  
12 capitalized for tax purposes, as was PacifiCorp's previous practice. This would  
13 include the impact of "bonus" depreciation at 50 percent for qualifying new plant.

14 In Staff Data Request 148, which is included as my Exhibit No. \_\_\_\_  
15 (KHB-4), Staff requested the Company prepare an analysis to reflect the removal of  
16 the repairs deduction, but the Company refused on the basis the request was "unduly  
17 burdensome", among other reasons.

18  
19 **Q. Does the impact of the Repairs Deduction to the 2009 test year exemplify the**  
20 **rate making issues of flow-through accounting for income taxes?**

---

<sup>13</sup> The revenue requirement is calculated by the net rate base reduction of \$(28,927,370) multiplied by Staff's recommended rate of return, 7.48, divided by the conversion factor of 0.61988.

<sup>14</sup> PacifiCorp included a reduction of \$14,464,000 as reflected in Exhibit \_\_\_\_ (RF-5).

1 A. This accounting change is an extreme example of an opportunity taken by a utility  
2 that results in significant benefits. Since PacifiCorp incorporated this cumulative  
3 change with its 2008 federal income tax return the Company filed in 2009, the 2009  
4 test year in this rate case reflects a significant reduction in taxes payable. If 2009  
5 had not been PacifiCorp's test year, the entire benefit could have escaped rate  
6 making treatment, even though the ratepayers paid in rates for the utility assets that  
7 gave rise to the deduction.

8 Under the flow-through method, the total unprotected amount, for years 1999  
9 through 2009, would be reflected in the currently used test year. Under  
10 normalization, this amount would be deferred and recognized over the life of the  
11 asset, similar to how PacifiCorp recorded it prior to the change.

12  
13 **D. Policy Considerations**

14  
15 **Q. Has the Commission addressed the repairs deduction in other cases?**

16 A. Yes. In a Puget Sound Energy ("PSE") rate case, Dockets UE-090704 and UG-  
17 090705 (consolidated), the Commission rejected a pro forma adjustment proposed by  
18 Federal Executive Agencies to include PSE's repairs deduction adjustment, which  
19 PSE had included in its 2008 federal income tax return.<sup>15</sup>

20  

---

<sup>15</sup> *UTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705 (consolidated), Order 11, at Page 70 ¶ 197 (April 2, 2010).

1 **Q. Are there any important differences surrounding PacifiCorp's repair deduction**  
2 **compared to PSE's?**

3 A. Yes. In the PSE docket, the proposed pro forma adjustment for PSE went far beyond  
4 the test year, whereas PacifiCorp actually recognized this tax accounting method  
5 change during the test year. In particular, the test year in Docket UE-090704 was the  
6 twelve months ending 2008, and the test year in this case is the twelve months  
7 ending 2009. PSE signed its consent letter with the IRS to make the tax accounting  
8 method change in September of 2009, similar to PacifiCorp.<sup>16</sup> Both companies  
9 included the repairs deduction method change with their 2008 federal income tax  
10 return recorded on their accounting books in September of 2009.

11  
12 **Q. Are there any ratemaking principles that justify considering PacifiCorp's**  
13 **repairs deduction differently from PSE's repair deduction in Docket UE-**  
14 **090704?**

15 A. Yes. In the PSE docket, the Commission was concerned about the remoteness of the  
16 adjustment and the inability to consider offsetting factors. As the Commission stated  
17 in Order 11 in Docket UE-090704, at page 12, paragraph 29:

18 This second aspect of the offsetting factors evaluation makes the question of  
19 remoteness from the test year important when considering proposed pro  
20 forma adjustments. The further out the point at which a proposed pro forma  
21 adjustment is known and measurable, the less sure the Commission can be  
22 that there are no offsetting factors – direct or indirect. Thus, any proposed  
23 adjustment that becomes known and measurable more than a few months  
24 after the test year is inherently suspect and requires a greater showing, if it is  
25 to be allowed.

---

<sup>16</sup> PacifiCorp signed its consent letter in October 2009.

1  
2 These concerns do not apply in this case because the tax filing, payment and  
3 resulting accounting entry occurred during the test period, and reflect known and  
4 measurable accumulated deferred tax balances related to the test period, therefore  
5 fulfilling the requirements of the matching principle.

6  
7 **V. RESERVE RECOGNITION**

8  
9 **A. Background**

10  
11 **Q. What is a “reserve”?**

12 A. In this instance, “reserve” refers to the establishment of a contingent liability.  
13 PacifiCorp requests Commission permission to establish a reserve for interest  
14 resulting from an adverse IRS audit finding regarding the repairs deduction the  
15 Company included in its 2008 and 2009 federal income tax filings.

16  
17 **Q. Is the repairs deduction subject to audit by the IRS?**

18 A. Yes. The consent agreement between the IRS and PacifiCorp allows PacifiCorp to  
19 adopt the new methodology, but the Company’s calculations and application of the  
20 methodology are subject to audit by the IRS.

1 **Q. How is this issue addressed by the IRS nationally?**

2 A. This issue is a cross-industry issue and is being handled by the IRS as a “Tier 1”  
3 issue. The IRS tier system provides a consistent process for addressing significant  
4 compliance risk nationally. The IRS describes Tier 1 issues as being “of high  
5 strategic importance to Large and Mid-Size Business Examination Process  
6 (“LMSB”) and have significant impact on one or more industries. Tier 1 issues could  
7 include areas involving a large number of taxpayers, significant dollar risk,  
8 substantial compliance risk or high visibility, where there are established legal  
9 positions and/or LMSB direction.”<sup>17</sup>

10 In August 2009, the IRS issued a Revenue Procedure<sup>18</sup> that added this  
11 deduction to a list of method changes that can be recognized by a taxpayer pursuant  
12 to IRS consent. Companies are making this method change now to get their  
13 deduction early and reflect an adjustment for prior years. Taxpayers are concerned  
14 that once the regulations are final, the IRS may not allow the taxpayer to adjust prior  
15 years’ tax returns.<sup>19</sup>

16

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<sup>17</sup> <http://irs.gov/businesses/corporations/> LMSB at a Glance – Issues Tiering Fact Sheet.

<sup>18</sup> According to the IRS: “Revenue Procedure 2009-39 provides automatic consent provisions for Change in Accounting Methods for a taxpayer that wants to change their method of accounting from capitalizing under § 263(a) costs paid or incurred to repair and maintain tangible property to treating them as repair expenses under §§ 162 and 1.162-r. This Revenue Procedure also applies to taxpayers that want to change their unit of property to determine deductibility of repairs. Taxpayers must follow specific rules including stipulating certain criteria and filing a third copy of Form 3115.”

<sup>19</sup> *Platts Electric Week* (April 26, 2010) at page 35. This periodical quotes David Yankee (partner, National Energy Tax Services, at Deloitte Tax LLP in Chicago) as follows: “Part of the reason people aren’t waiting for the final regulations [to claim the deduction] is, if you have a sense of where they’re headed, why not get your deduction now? Plus, there’s a concern that when the regulations are final, they will not allow a catch-up adjustment, whereas the revenue procedure does – so why wait and risk the chance it won’t?”

1 **Q Is the Company's entire federal income tax return for 2008 and subsequent**  
2 **years subject to audit by the IRS?**

3 A. Yes.

4

5 **Q. Are all tax returns for all companies subject to IRS audit?**

6 A. Yes. IRS auditing the tax return is a normal course of business.

7

8 **B. PacifiCorp's Reserve Recognition Proposal**

9

10 **Q. Please describe the Company's proposal for Reserve Recognition.**

11 A. The Company requests permission to establish a reserve for interest related to any  
12 adjustment made by the IRS to the repairs deduction the Company included in its  
13 2008 and 2009 federal income tax returns.<sup>20</sup>

14

15 **C. Policy Considerations**

16

17 **Q. Has the Commission dealt with adverse IRS audit determinations in the past?**

18 A. Yes. One example involved PSE's use of the simplified service cost method  
19 ("SSCM"). This method allows a taxpayer to deduct costs related to labor and  
20 overheads that would otherwise be capitalized. The IRS audited PSE's adoption and

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<sup>20</sup> Exhibit No. \_\_\_\_ (RF-1T) Page 5 lines 11-14.

1 use of the SSCM and disallowed all of PSE's deductions. As a result of a settlement  
2 with the IRS Appeals office, the IRS allowed PSE to retain 85% of its original  
3 deductions, but required PSE to pay interest on the disallowance.

4 Prior to this adverse ruling, for ratemaking purposes, PSE reflected the tax  
5 benefit of the change on a normalized basis. The Commission treated the deferred  
6 tax benefit as a rate base reduction in Docket UG-040640, et al.<sup>21</sup> After the  
7 disallowance by the IRS was a known and measurable event, the Commission  
8 allowed PSE to recover the financing costs it incurred to pay the IRS, in Docket UE-  
9 060266.<sup>22</sup> However, in Docket UE-090704, the Commission denied PSE recovery of  
10 the interest assessment resulting from the IRS Audit settlement.<sup>23</sup>

11  
12 **Q. Has the Commission previously addressed the issue of creating a reserve in a**  
13 **similar context?**

14 A. Yes. In Docket UG-040640, et al., the Commission addressed this issue in the  
15 context of its discussion of PSE's use of SSCM, stating:

16 We cannot lawfully prejudge future rates. However, we do find it appropriate  
17 to recognize in principle that if the IRS successfully challenges in court the  
18 adjustment PSE and other utilities have taken, and requires future repayment  
19 of the current benefits taken, presumably with interest, PSE should file an  
20 accounting petition asking for appropriate treatment of any back taxes and  
21 interest assessed.<sup>24</sup>

22  

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<sup>21</sup> *UTC v. Puget Sound Energy, Inc.*, Dockets UG-040640, UE-040641, UE-031471 and UE-032043 (consolidated), Order 8 at page 59, ¶ 156 (February 18, 2005).

<sup>22</sup> *UTC v. Puget Sound Energy, Inc.*, Dockets UE-060266 and UG-060267, Order No. 08 (January 5, 2007).

<sup>23</sup> *UTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705 (consolidated) Order 11 at page 68, ¶ 191 (April 2, 2010).

<sup>24</sup> *UTC v. Puget Sound Energy, Inc.*, Dockets UG-040640, UE-040641, UE-031471 and UE-032043 (consolidated), Order 8 at page 59, ¶ 159 (February 18, 2005).

1 Commission rules (WAC 480-07-370(1)(b)) permit PacifiCorp to file an  
2 accounting petition to request deferral of material costs for future rate consideration.  
3 This would allow PacifiCorp to defer costs, once they become known and  
4 measurable, for Commission consideration in a future rate proceeding. It is  
5 premature for the Commission to grant such a request in this case.  
6

7 **D. Discussion**  
8

9 **Q. How much risk does the Repairs Deduction represent on audit by the IRS?**

10 A. Staff cannot assess the exact level of risk associated with this method change.  
11 However, the Company and IRS have consent letters in place approving the  
12 methodology. Moreover, PacifiCorp currently enjoys the benefits of this change,  
13 which results in a reduction in expenditures and an increase in cash flow. Staff  
14 would assume the Company considers the benefits to be greater than the risk, and  
15 therefore made the change.  
16

17 **Q. Do customers receive a benefit from PacifiCorp's proposed change in tax**  
18 **methodology?**

19 A. Yes. Customers receive the benefit related to the increase in accumulated deferred  
20 income tax for past years. However, the ongoing benefit over time is similar to what  
21 customers would have received absent the change.  
22



1 **Q. Should the Commission grant PacifiCorp's request to create a reserve?**

2 A. No. PacifiCorp's request is premature. PacifiCorp is asking to create a reserve or  
3 contingent liability for something that has not occurred, and may not occur. This  
4 request is not based on known or measurable factors.

5

6 **IV. CONCLUSION**

7.

8 **A. Reject Full Normalization**

9

10 **Q. Please summarize why the Commission should reject the Company's proposal**  
11 **of full normalization of federal income taxes.**

12 A. The Commission should reject the proposal by PacifiCorp for the following reasons:

13 1. **Unknown Full Impact of Normalization** - PacifiCorp only provided the  
14 impact of its proposal for 2009. The Company did not address the transition  
15 to full normalization, suggesting only that it will determine the final  
16 regulatory asset or liability in the next rate case.<sup>25</sup> This is not a proper  
17 decision making process related to the full adoption of normalization.

18 2. **Unknown Materiality or Rate Impact** – PacifiCorp did not provide  
19 evidence to determine the overall ratepayer impact of its proposal.

20 3. **Global Policy Issue** – This issue could affect all regulated utilities. If the  
21 Commission were to adopt this policy change for PacifiCorp it could apply to

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<sup>25</sup> Exhibit No. \_\_\_ (RF-1T), page 10 and 11.

1 all companies. This change would require full analysis on a case-by-case  
2 basis in order to fully understand the magnitude involving to all companies  
3 and their ratepayers.  
4

5 **Q. Please explain Staff's adjustment to remove the Company's Adjustment 7.9,**  
6 **Current Year Deferred Income Tax Normalization.**

7 A. As I have explained, the Company's Adjustment 7.9 removes the effects of flow-  
8 through for the year 2009. Staff's Adjustment 7.9 simply reverses the Company's  
9 adjustment consistent with flow-through and Staff's position that the Commission  
10 should deny the Company's request to adopt full normalization beginning January 1,  
11 2011.

12 Staff's adjustment increases net operating income by \$525,562, increases the  
13 net rate base by \$262,718, and decreases overall revenue requirement by \$816,135.  
14 These are all Washington figures.  
15

16 **B. Allow Normalization of the Repairs Deduction**  
17

18 **Q. Please explain why the Commission should allow normalization of the**  
19 **unprotected portion of the Repairs Deduction.**

20 A. The Commission should allow normalization of the unprotected portion of the  
21 repairs deduction for the following reasons, with the following test year effect:

- 1           1.     **The repairs deduction is known and measurable** – WAC 480-07-  
2                     510(3)(iii) defines pro forma adjustments as adjustments that "give effect for  
3                     the test period to all known and measurable changes that are not offset by  
4                     other factors." The known and measurable concept requires that an event  
5                     must have occurred during or after the test year, and the amount of the  
6                     change must be measurable. In this case, the event has happened and the  
7                     amount is measurable; PacifiCorp filed its tax return in September 2009, and  
8                     received the benefit of a reduction in taxes payable as a result of using the tax  
9                     accounting change for repair expenditures.
- 10           2.     **Flow-through can cause a significant test year impact** – In this instance,  
11                     the repairs deduction creates a significant benefit on a flow-through basis,  
12                     \$30,886,155 to Washington, in one year, due to the restatement of 1999  
13                     through 2008.
- 14           3.     **Flow-Through may result in lost benefits to ratepayers** – If PacifiCorp  
15                     had not used 2009 as the test year in this rate case, ratepayers could have lost  
16                     the recognition of the full benefit of this adjustment on a flow-through basis.
- 17           4.     **Normalization allows for recovery over the life of the asset.** - This  
18                     adjustment reflected on a normalized basis provides the benefit to ratepayers  
19                     over the remaining life of the asset. It provides for more consistent recovery  
20                     over time as well as mitigates any possible lost benefit.
- 21           5.     **The Commission has approved normalization for many single issues.**  
22                     Examples are provided above on page 8.

1

2 **Q. Please explain Staff's Adjustment 8.11, Repairs Deduction.**

3 A. PacifiCorp has reflected the repairs deduction as if it was included in the test year for  
4 half of the year.<sup>26</sup> The Company reflected this adjustment to its 2008 federal income  
5 tax return as an accounting adjustment in September of 2009, but it represents the  
6 cumulative effect of 1999 through 2008 on the Company's accumulated deferred tax  
7 balance.

8 Staff's Adjustment 8.11 portrays the repair adjustment for the entire year to  
9 restate the test year balance for the prior year adjustment. This adjustment reduces  
10 net rate base by an additional \$14,463,670, or a reduction in revenue requirement of  
11 \$1,745,310. These are Washington figures.

12

13 **C. Deny Reserve Recognition**

14

15 **Q. Please explain why the Commission should reject PacifiCorp's request to create a**  
16 **reserve for interest related to a future IRS audit of PacifiCorp's repair deduction.**

17 A. The Commission should deny the Company's request to establish a reserve or  
18 regulatory asset or liability for interest related to the repairs deduction taken in the  
19 Company's 2008 and 2009 federal income tax returns. As confirmed by the  
20 Commission in UG-040640, et al., the Company has the opportunity to request a  
21 deferral through WAC 480-07-370(1)(b) by filing an accounting petition, if the

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<sup>26</sup> Exhibit No. \_\_\_\_ (RF-5).

1 outcome of the IRS audit of their 2008 federal income tax return actually results in a  
2 change.

3

4 **Q. Does this conclude your testimony?**

5 A. Yes.