

Rocky Mountain Power
Docket 07-035-93
Witness: Jonathan D. Hale

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF UTAH

ROCKY MOUNTAIN POWER

Rebuttal Testimony of Jonathan D. Hale

Income Taxes

May 2008

1 **Q. Please state your name, business address and present position with Rocky**
2 **Mountain Power (the Company).**

3 A. My name is Jonathan D. Hale. My business address is PacifiCorp, 825 NE
4 Multnomah, Suite 1900, Portland, Oregon 97232. My current position is Senior
5 Tax Director.

6 **Qualifications**

7 **Q. Mr. Hale, please briefly describe your education and business background.**

8 A. I received a Masters in Tax from Brigham Young University in 1995. I am a
9 certified public accountant in Oregon and Washington. I was employed at Deloitte
10 Tax LLP for 10 years. I joined PacifiCorp in 2005 as Tax Director. In June 2006
11 I was promoted to Senior Tax Director.

12 **Q. Please describe your present duties.**

13 A. I am responsible for all aspects of the Company's income tax function including:
14 compliance, accounting, financial and management reporting, issues resolution,
15 planning, and tax related regulatory filings.

16 **Purpose of Testimony**

17 **Q. What is the purpose of your testimony in this proceeding?**

18 A. I respond to the testimony of Mr. Kevin Higgins, testifying on behalf of the UAE
19 Intervention Group and Wal-Mart Stores, Inc. Mr. Higgins proposes an increase
20 in the projected Domestic Production Activity Deduction included in this case. I
21 also respond to the testimony of Ms. Donna DeRonne on behalf of the Committee
22 of Consumer Services (CCS) regarding potential increases in Bonus Depreciation
23 under the Economic Stimulus Package of 2008. Finally, I respond to the

24 testimony of Mr. Brill of the Division of Public Utilities (DPU) and Ms. Cheryl
25 Murray of CCS on the Company's proposed change to normalization.

26 **Q. Please summarize your testimony.**

27 A. I explain that the Domestic Production Activity Deduction should reflect an
28 amount that corresponds with the final determined revenue requirement in this
29 case. I also explain, however, that the calculation of the Domestic Production
30 Activity Deduction has become a moot issue in this case because the Company is
31 not able to recognize this deduction with Bonus Depreciation available to it in
32 2008.

33 My testimony sponsors the adjustment for Bonus Depreciation for this
34 case. I outline the net revenue requirement impact of removing the Domestic
35 Production Activity Deduction and adding Bonus Depreciation.

36 Finally, I provide support for the Company's proposed change from 40
37 percent normalization of book basis differences to 100 percent normalization of
38 book basis differences related to property depreciation. This change lowers
39 revenue requirement in this case by approximately \$13 million. The Company
40 proposes to change normalization in this manner only if the Commission accepts
41 the change in the 40 percent to 100 percent normalization on an ongoing basis,
42 not just for this case. If the Commission wants further review of this issue, it
43 should reject the proposal and increase revenue requirement by \$13 million to
44 reflect continued adherence to 40 percent normalization.

45 **Income Tax Domestic Production Activities Deduction**

46 **Q. Please provide background on the Domestic Production Activity Deduction.**

47 A. The Domestic Production Activity Deduction was enacted in October 2004
48 through the American Jobs Creation Act of 2004. The deduction is permanent
49 (*i.e.*, there is no corresponding book deduction in the current or future year). It is
50 based on a percentage of the Net Production Taxable Income. For 2008 and 2009
51 that percentage is 6 percent. The definition of the net production taxable income
52 has not yet been defined in the law or regulations for a fully integrated electric
53 utility. The Company's method of calculation has evolved since the law was first
54 introduced, based on the electric utility industry's understanding of the
55 methodology anticipated to be preferred by the Internal Revenue Service (IRS).

56 **Q. What considerations informed the development of the Domestic Production**
57 **Activity Deduction for this case?**

58 A. This deduction is tied to the amount of Net Production Taxable Income in the
59 case, not to the retail Company pre-tax income. This means that any adjustment to
60 revenue requirement should correlate the Net Production Taxable Income to the
61 Domestic Production Activity Deduction. The Company based the Domestic
62 Production Activity Deduction on the relationship between: (i) the last filed
63 federal tax return Total Company Net Taxable Income; and (ii) the Production
64 Activity Income used in the calculation of the Domestic Production Activity
65 Deduction for that tax return.

66 **Q. How is the Domestic Production Activity Deduction calculated in this rate**
67 **case?**

68 A. The Domestic Production Activity Deduction is built on the ratio of the
69 Production Activity Income in the last filed federal tax return to the Total
70 Company Net Taxable Income from the last filed federal tax return. Since the
71 majority of the additions placed in service are production related, the Tax Bonus
72 Depreciation will alter this ratio. The calculation of the ratio above is adjusted to
73 remove the tax depreciation entirely from the numerator and the denominator so
74 that the actual amount of production related tax depreciation including Tax Bonus
75 Depreciation is included in calculating the Domestic Production Activity
76 Deduction. This more appropriately reflects the level of Production Taxable
77 Income.

78 **Q. Does Mr. Higgins apply a different calculation to determine the Domestic**
79 **Production Activity Deduction?**

80 A. No. Mr. Higgins advocates for a deduction of \$12 million based upon the
81 Company's estimated deduction for the twelve months ending June 2008. This
82 estimate was based on the same calculation but used a different Total Company
83 Net Taxable Income. The Domestic Production Activity Deduction must be based
84 on Net Production Taxable Income set by the Commission in this case using a
85 calendar year 2008 test period. It should not be based on the estimated income for
86 a different period with no relationship to what the Company will be able to
87 recognize on its federal tax return.

88 **Q. Has Mr. Higgins correctly stated the Company’s projected pre-tax income as**
89 **a number in excess of \$825 million before a rate increase?**

90 A. No. Mr. Higgins’ calculation of \$825 million refers to pre-tax book income
91 before taking into account Schedule M differences of \$398 million, interest
92 expense deductions for tax of approximately \$289 million and Tax Bonus
93 depreciation. These adjustments reduce pre-tax income for calculating the
94 Domestic Production Activity Deduction to approximately \$137 million, the
95 amount used to calculate the deduction included in the Company’s original filing.

96 **Q. Has the Total Company Net Taxable Income for this case decreased?**

97 A. Yes. As updated in the Company’s rebuttal filing, the appropriate level of Total
98 Company Net Taxable Income for this case before the final Commission’s order
99 in this case is now the \$86.6 million as shown in Exhibit RMP___(SRM-1R-RR)
100 p. 2.20, Line 1287. Once the final number, as determined by this Commission, is
101 known, the Domestic Production Activity Deduction will need to be calculated
102 again based on the final ordered number.

103 **Q. Has the proper level of the Domestic Production Activity Deduction become**
104 **moot in this case?**

105 A. Yes. Given the revised level of Total Company Net Taxable Income after the
106 addition of the Tax Bonus Depreciation, the \$3 million Domestic Production
107 Activity Deduction in the case is reduced to zero. As set forth in Internal
108 Revenue Code §199(a)(1), the deduction is limited to “the lesser of - (A) the
109 qualified production activities income of the taxpayer for the taxable year, or (B)
110 taxable income (determined without regard to this section) for the taxable year.”

111 With a Total Company Net Taxable Income of zero or less, there can be no
112 Domestic Production Activity Deduction.

113 **Bonus Depreciation**

114 **Q. Ms. DeRonne testifies for CCS that the Company should have updated the**
115 **filed case for the newly enacted Economic Stimulus Act of 2008 to include**
116 **Bonus Depreciation. What is the Company's position on Ms. DeRonne's**
117 **recommendation?**

118 A. To ensure that rates in this case reflect the most accurate information available on
119 the Company's costs, the Company accepts CCS's recommendation. The
120 Company could not reasonably have included this information earlier in the case
121 because the Economic Stimulus Act of 2008 was not enacted until February 13,
122 2008.

123 **Q. How have you determined the Bonus Depreciation for this case?**

124 A. Since the enactment of the Economic Stimulus Act of 2008 in mid-February, the
125 Company has been actively researching the estimated in-service dates of qualified
126 additions for 2008 and 2009 to determine the best means for capturing the
127 maximum benefit from this Act. This is a collaborative effort on the part of many
128 departments to ensure that the decisions for putting property in service to take full
129 advantage of this benefit are complete and accurate. There are several criteria that
130 have to be met such as:

- 131 1. the property's original use must be with the Company;
- 132 2. the property must be placed in service after December 31, 2007 and before
133 January 1, 2009, but only if no binding written contract with respect to the

134 acquisition or construction of the property is in effect before January 1,
135 2008;

136 3. the property must qualify for MACRS (the Internal Revenue Code and
137 related regulations prescribe the standard tax depreciation system known as
138 Modified Accelerated Costs Recovery System, or MACRS) with a recovery
139 period of 20 years or less;

140 4. there is a limited extension period for property placed in service after
141 January 1, 2009, which must have a tax depreciable life of 10 years or
142 longer, a construction period exceeding one year, cost exceeding \$1 million,
143 and in service date prior to January 1, 2010, and finally only costs incurred
144 prior to January 1, 2009 are eligible to the extent criteria 1 through 3 are
145 also met in full.

146 **Q. What is your estimate for Bonus Depreciation?**

147 A. Based on the Additions in the December 2008 rate base in the case, an estimated
148 \$220 million tax basis in plant qualifies for Bonus Depreciation. The estimated
149 Bonus Depreciation deduction on which deferred tax expense would have to be
150 normalized was calculated as \$110 million. Updating the case for the actual in-
151 service additions through February 2008, with the addition of Bonus
152 Depreciation, the estimated net change to Tax Depreciation is an increase of \$75.6
153 million. The corresponding net change to the deferred tax expense is an increase
154 of \$29.9 million.

155 **Q. How does this impact the Domestic Production Activity Deduction?**

156 A. As noted above, the Domestic Production Activity Deduction is reduced to zero

157 since the Bonus Depreciation, which factored into other taxable income
158 computations, creates a loss for federal taxable income purposes in this case.
159 Utah’s net change to Total Income Tax Expense for removing the Production
160 Activity Deduction but adding in the deduction for Tax Bonus Depreciation is a
161 revenue requirement increase of \$964,000.

162 **Full Normalization of Deferred Income Taxes**

163 **Q. Please explain full normalization.**

164 A. Full normalization is the concept of providing deferred tax expense to completely
165 offset all book and tax timing differences occurring in current tax expense. The
166 term “normalization” evolved with respect to utilities because income taxes
167 computed on the normalization basis caused reported net income to appear
168 “normal”, as if the utility had not adopted a tax return method of calculating its
169 tax expense. Full normalization is more properly cost-based for ratemaking
170 purposes than flow-through, because it more equitably allocates tax costs over
171 time to generations of consumers the tax benefits and costs of utility property
172 investments.

173 **Q. What is flow-through?**

174 A. Flow-through is the term used for passing through in the current period the
175 impacts of book and tax timing differences to income, with no offset of deferred
176 tax expense.

177 **Q. How are deferred tax expenses developed on depreciation related**
178 **differences?**

179 A. Accelerated tax depreciation is a reduction to current tax expense. The book

180 depreciation is an addition for tax purposes to mathematically reverse its effects
181 from book income. The net impact of both of these adjustments (add book
182 depreciation and subtract tax depreciation) is, in the early years of a property's
183 useful life, a reduction to current tax expense. Therefore the deferred tax expense
184 needs to be an increase in deferred tax expense to offset (normalize) the current
185 tax expense reduction. So, to calculate the deferred tax expense, the book
186 depreciation is subtracted from the tax depreciation, in a full normalization
187 scenario, creating a net debit to the deferred expense account. In later years of a
188 property's useful life, tax depreciation goes to zero, while book depreciation
189 continues. During this later period, the deferred income tax previously
190 accumulated will reverse as credits to income tax expense with corresponding
191 reductions of accumulated deferred income taxes.

192 **Q. Is the Utah jurisdiction a full normalization jurisdiction?**

193 A. No. The only portion of timing differences that do not have 100 percent deferred
194 tax expense provided are the book basis differences related to depreciable
195 property. The book basis differences only have 40 percent of deferred taxes
196 provided.

197 **Q. Please explain what 40 percent of deferred taxes provided means.**

198 A. First, it needs to be emphasized that the book basis differences are the only
199 differences to which the 40 percent is presently applied by the Commission. All
200 other book-tax method and life depreciation differences related to property are
201 100 percent normalized, as required by IRS regulations. As an example, AFUDC
202 is a book basis difference and is only 40 percent normalized. What this means is

203 that for a book in-service addition of \$10 million, the AFUDC is assumed to be 8
204 percent of that in-service addition, or \$800,000. Assume that the total in service
205 book addition is then \$10.8 million. Assume this asset is a steam plant with a
206 book life of 40 years depreciated for book purposes on a straight-line basis. The
207 book depreciation of each year would be \$270,000. The AFUDC portion of the
208 \$270,000 book depreciation is \$20,000 (*i.e.*, \$800,000 divided by 40 years). The
209 \$20,000 is the first year of book depreciation on the AFUDC basis difference of
210 \$800,000. The first year of book depreciation of \$20,000 is subtracted from the
211 AFUDC basis difference of \$800,000 to yield a \$780,000 book-tax difference on
212 a balance sheet basis. The 40 percent normalization level is applied to the
213 \$780,000 difference for the year in service of this asset. The book basis negative
214 deferred tax expense would be \$780,000 times the tax rate of 37.951 percent, or
215 approximately \$296,000. Applying the 40 percent normalization to that result
216 equals \$118,000 for the negative deferred tax expense related to the book basis
217 difference. On the other hand, if the book basis difference in this example were
218 100 percent normalized as opposed to 40 percent, the negative deferred tax
219 expense on the book basis difference would be the \$296,000. That is a reduction
220 in net deferred tax expense of approximately \$178,000, or the difference between
221 the book basis deferred at 100 percent versus 40 percent (\$296,000 vs. \$118,000).
222 This illustrates that to move to 100 percent normalization is a net benefit to the
223 customers in this case.

224 **Q. What happens to the benefits going forward?**

225 A. While the benefit realized in the first year drops off, on a cumulative basis,

226 customers continue to see a benefit. Additionally, as new investments are brought
227 into rate base, the normalization process begins for those new assets, with
228 customers again realizing benefits in the first year.

229 **Q. Are there any other points that need to be raised?**

230 A. Yes, matching of costs and tax benefits is better achieved, as full normalization
231 provides deferred tax expense for every timing related current tax expense, so that
232 no timing difference flows through to total tax expense. With full normalization
233 the tax expense is matched to the book expense, unlike the lack of matching under
234 a flow-through method. The tax expense under flow-through in the example
235 above would reflect an additional current tax expense related to the \$4,554 with
236 no deferred tax offset. Full normalization also normalizes tax costs throughout
237 the useful life of the underlying asset, so that no disparity in tax cost exists among
238 generations of rate payers served by the underlying asset.

239 **Q. Please summarize how customers benefit from the proposed change in**
240 **normalization percentages.**

241 A. The proposed change produces a \$13 million revenue requirement reduction in
242 this case. Longer-term, the proposed change will help smooth the first year
243 revenue requirement impact associated with bringing new resources into rate
244 base. As Mr. Walje testifies, the Company is in the midst of an unprecedented
245 capital investment program. The proposed change will mitigate potential rate
246 spikes associated with the Company's increasing rate base.

247 **Q. What are the options available to the Commission in deciding this issue?**

248 A. The Commission has the following two options:

- 249 • The Commission could move to full normalization and the current case
250 would be correct as it stands.
- 251 • The Commission could reject the move to full normalization and increase
252 the revenue requirement by \$13 million. This decision would leave the
253 basis differences at a 40 percent level.

254 **Q. What does the Company recommend?**

255 A. The Company believes that the Commission should adopt the first option, accept
256 the adjustment as proposed and move to full normalization in the current case. No
257 additional adjustments would be needed to the case as it stands currently.
258 Alternatively, if the Commission is uncomfortable with this approach because
259 parties want time to review the adjustment, then the Commission can reject the
260 adjustment, increase the case by \$13 million and take up the issue at another time.

261 **Q. It appears that parties to the case want the benefit of the \$13 million revenue
262 requirement reduction but they are not willing to accept change to full
263 normalization which produces this reduction. Can they accept one without
264 the other?**

265 A. No. The Commission cannot in good faith accept the \$13 million benefit in this
266 case, but then decide in the next case that the underlying tax treatment should be
267 reversed and continue on at 40 percent normalization. This kind of result-oriented
268 switching in approaches would violate fundamental ratemaking principles of
269 matching, consistency and fairness. Additionally, from a practical perspective,
270 case-specific changes in normalization could produce significant tracking and
271 auditing challenges, since the Company’s regulatory tax models assume general
272 consistency in normalization conventions.

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

274 **A. Yes.**