COMMENTS
IN RESPONSE TO
INTERNAL REVENUE SERVICE
NOTICE OF PROPOSED RULEMAKING

26 CFR PART 1
[REG-104385-01]
RIN 1545-AY75

APPLICATION OF NORMALIZATION ACCOUNTING RULES TO BALANCES OF EXCESS DEFERRED INCOME TAXES AND ACCUMULATED DEFERRED INVESTMENT TAX CREDITS OF PUBLIC UTILITIES WHOSE GENERATION ASSETS CEASE TO BE PUBLIC UTILITY PROPERTY

ON BEHALF OF

ALLIANCE FOR VALLEY HEALTHCARE
AND
HOUSTON COUNCIL FOR HEALTH AND EDUCATION

PREPARED BY

LANE KOLLEN, CPA, CMA
J. KENNEDY AND ASSOCIATES, INC.
570 COLONIAL PARK DRIVE
SUITE 305
ROSWELL, GEORGIA 30075
770-992-2027

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Statement of Interest and Impact of Proposed Regulation

The Alliance of Valley Healthcare (AVH) and the Houston Council for Health and Education (HCHE) are ad hoc groups consisting of hospitals, other health care facilities and/or universities. The AVH companies have been and continue to be customers and ratepayers taking electric service from AEP Texas Central Company (TCC). HCHE companies have been and continue to be customers and ratepayers taking electric service from CenterPoint Energy Houston Electric (CNP). The members of these two ad hoc groups historically have been and prospectively will be responsible for paying the costs of utility generation assets formerly owned by these utilities. Prior to deregulation in Texas these ratepayers paid the costs of utility generation assets through bundled rates. Subsequent to deregulation, these ratepayers pay the costs of generation assets through a combination of market rates and regulated stranded costs. The excess deferred income tax (EDFIT) and accumulated deferred investment tax credit (ADITC) have been significant issues in proceedings before the Public Utility Commission of Texas (PUCT) to address the issues of generation asset cost recovery for the utilities, including the recovery of stranded costs.

The PUCT has found in multiple proceedings involving CNP, TCC and Texas New Mexico Power Company (TNMP) that the generation-related EDFIT and ADITC amounts for each utility are appropriately allocated entirely to the ratepayers and not to the utilities, although the carrying charge effects of the ADITC have been allocated to the utilities consistent with the historic ratemaking treatment of the ADITC reserves. The PUCT has used or stated its intent to use these EDFIT and ADITC amounts to reduce the stranded cost recoveries by the three utilities associated with their deregulated generation assets. The total generation-related EDFIT and ADITC benefits that will be affected by the Proposed Regulation is $378 million for the three utilities on a nominal dollar basis. In ratemaking and for stranded cost purposes, these amounts are grossed-up to before tax

revenue requirement amounts, which means that there is a nominal amount of $581 million that is at issue in Texas and that will be affected by this Proposed Regulation.

Consequently, the issuance of this Proposed Regulation directly and significantly affects AVH and HCHE companies and all other ratepayers of the Texas utilities. If this Proposed Regulation is not modified, all ratepayers of the Texas utilities will lose the entirety of the EDFIT and ADITC tax benefits inherent in cost-based regulation and already ordered by the PUCT to be used as reductions to stranded cost recovery. The ratepayers will lose the EDFIT and ADITC tax benefits if the IRS determines that either 1) there will be normalization violations if all or a portion of these tax benefits are flowed through to ratepayers, or 2) the effective dates of the Final Regulation effectively precludes the flow-through of all or a portion of these tax benefits. To the extent that the Final Regulation on the EDFIT and ADITC issues results in whole or part in normalization violations, these tax benefit amounts will be transferred from ratepayers, who were and continue to be responsible for the underlying costs of the investments, to the utilities, which have no responsibilities for the prudent and reasonable underlying costs of the investments.

Summary of Comments

The Proposed Regulation represents a substantial change from the 2003 Proposed Regulation and should be modified to reflect both the rationale and the result of the 2003 Proposed Regulation before the Final Regulation is issued. The Proposed Regulation effectively will eliminate all flow-through of EDFIT and ADITC amounts to ratepayers in pending and future Texas stranded cost proceedings, a result that is contrary to the rationale articulated in the 2003 Proposed Regulations for both EDFIT and ADITC and inconsistent with the prior and ongoing responsibility for payment by ratepayers of the costs of generation assets formerly owned by the utilities. In the Final Regulation, the effective date provisions of the Proposed Regulation should be modified to allow an election for retroactive application and to allow flow-through of the EDFIT and ADITC reserves in the pending Texas proceedings over the same period as stranded cost recovery is allowed or to otherwise grandfather the Commission's determination that these amounts are properly allocated to ratepayers even if final orders have not been entered to implement these decisions. In addition, the Final Regulation should allow for the full unamortized ADITC reserve to be flowed-through to the ratepayers, not only a portion based on the percentage of stranded costs to the total cost of the generation assets. Ratepayers remain responsible for the entire cost of the assets through both a non-stranded cost market component and the stranded cost component.

Description of Cost-Based Regulatory Scheme Before and After Deregulation

Under historic cost-based regulation, the ratepayers were responsible for the entirety of the prudent and reasonable costs of generation assets acquired or constructed by the utilities and used to provide regulated electric service. Under cost-based regulation, there was no sharing of these costs between the utilities and their ratepayers. The ratepayers paid a return on the undepreciated cost of the generation assets and paid for the cost through depreciation expense over the regulatory life of the generation assets. In exchange for this obligation to pay the entirety of the prudent costs of generation assets, the cost to the ratepayers was reduced by the EDFIT and ADITC tax benefits. In the case of the EDFIT, the ratepayers received a return on the unamortized EDFIT and a further credit for the amortization of the EDFIT related to the generation assets. In the case of the ADITC, the ratepayers received only a credit for the amortization of the ADITC related to the generation assets, consistent with the utilities' elections pursuant to the former section 46(f)(2) of the IRC. As such, the utilities retained the carrying charge benefit from the unamortized ADITC.

Under the Texas statutory deregulation scheme, the Texas legislature retained the underlying principle that the ratepayers remained responsible for the entirety of the prudent costs of generation assets. A portion of the costs of the generation assets was transferred by the utilities to third party purchasers through the sale of generation assets or through the sale of the affiliated company that owned the generation assets. Now the third party purchasers recover their costs through market rates by selling electricity to marketers (retail electric providers in Texas), who in turn recover their costs by selling bundled generation and delivery service to ratepayers. The utilities recover any remaining portion of the cost of the generation assets (not recovered through the sale of their assets to third parties) through stranded cost charges paid by marketers, who in turn would recover these costs directly from ratepayers. Thus, regardless of the form of recovery, the result is the same and the ratepayers remain responsible for the entire cost of the generation assets.

In the situation of sales of the generation assets (TNMP and TCC), the EDFIT and ADITC could not be and were not transferred to the purchaser and the selling utility retained the remaining unamortized amounts of EDFIT and ADITC. In the situation of the sale of the affiliated Company holding the generation assets (CNP), the utility retained the EDFIT and booked it to income. The ADITC was transferred from the affiliated Company holding the generation assets to the purchaser of that Company, but likely was foregone by the purchaser in exchange for a step-up in the tax basis of the assets. The Commission concluded in the TNMP, CNP and TCC regulatory proceedings that the entirety of the EDFIT and ADITC related to the generation assets would be allocated to ratepayers and used to reduce the stranded cost recovery rather than be allocated in part to the selling utility on the basis of some ratio of market or stranded costs to the total undepreciated cost of the generation assets. The Commission provided the carrying charge benefit of the ADITC to the utilities consistent with prior regulation and the normalization requirements under former section 46 of the Internal Revenue Code (IRC).

Statement Supporting Modification of Proposed Regulation and Rationale

The Proposed Regulation will upend the cost-based regulatory scheme in Texas, contravene existing rate orders allocating the EDFIT and ADITC benefits to ratepayers, cause ratepayers substantial harm, and provide utilities inappropriate windfalls. The Proposed Regulation essentially will strip all the EDFIT and ADITC benefits that were allocated by the PUCT to ratepayers from them and transfer those benefits to the utilities. The Proposed Regulation is not an esoteric exercise; it will have a real-world effect. This real-world result would be in contravention of the general principles and legislative intent underlying the normalization provisions of the IRC, which generally allocate these tax benefits to ratepayers, except for the carrying charges on the ADITC. In addition, the Proposed Regulation improperly interferes in the Texas legislative scheme for deregulation of the electric generation function and recovery of costs from ratepayers through a combination of cost recovery by the utility through market sales and stranded cost ratemaking recovery. Finally, the PUCT already has issued final rate orders allocated the EDFIT and ADITC to the ratepayers of the three utilities.

The general principle upon which the normalization requirements rest is that these tax benefits may and should be flowed-through to the ratepayers who are responsible for the underlying costs of the investment, but that the benefits may not be flowed-through more rapidly than on a prorata basis over the regulatory lives of the assets. In the absence of the normalization requirements, the EDFIT and the ADITC could have been, and most likely, would have been, flowed through to ratepayers by state regulatory commissions more rapidly than on a prorata basis over the regulatory lives of the assets. The evidence of this fact is the existence of the normalization requirements themselves, which were legislated by Congress to constrain a more rapid flow-through to ratepayers, and also the experience of state regulatory commissions on the EDFIT that was not limited by section 203(e) of the 1986 Tax Reform Act. In almost every instance, the EDFIT that was not limited by the normalization requirements of section 203(e) of the 1986 Tax Reform Act was flowed-through to ratepayers over a more rapid amortization period.

The Proposed Regulation addresses the ability of utilities to continue to flow-through to ratepayers the effects of the EDFIT and ADITC reserves related to public utility property that ceases to be public utility property, whether through disposition, deregulation, or otherwise, without violating the normalization provisions of the I.R.C. The Proposed Regulation replaces the Proposed Regulation published March 4, 2003 addressing the same issues.

In general, AVH and HCHE agree with the rationale stated in the 2003 Proposed Regulation that allowed utilities to continue to flow-through the entirety of the effects of the EDFIT and ADITC reserves without violating the normalization provisions of the IRC, including the safe-harbor provision allowing the utility to elect to apply the provisions of the 2003 Proposed Regulation for periods prior to the date of publication. The 2003 Proposed Regulation provided the following rationale:

> **After further consideration, the Service and Treasury have concluded that neither former section 46(f)(2) nor section 203(e) of the Tax Reform Act suggests that the EDFIT and ADITC reserves should not ultimately be flowed through to ratepayers. Instead, Congress provided a schedule for flowing through the reserves so that utilities would have the benefit of cost-free capital for a predictable period.**
>
> **The proposed regulations provide that utilities whose generation assets cease to be public utility property, whether by disposition, deregulation, or otherwise, may continue to flow through EDFIT and ADITC reserves associated with those assets without violating the normalization rules. The rate of flowthrough is limited, however, to the rate that would have been permitted if the assets had remained public utility property and the taxpayer had continued to use a normalization method of accounting (or ratable flowthrough of the credit) with respect to the assets. This result does not impose on utilities any burden unanticipated prior to deregulation and provides the flow-through originally anticipated by ratepayers, utility commissions, and utilities.**

For EDFIT, the new Proposed Regulation continues to rely upon the logic expressed in the 2003 Proposed Regulation and allows the EDFIT benefit to be flowed through to ratepayers even after the deregulation or other disposition of public utility property. For EDFIT, the new Proposed Regulation states:

> **As noted in the preamble of the 2003 proposed regulations, the IRS and Treasury have concluded that section 203 of the 1986 Act provides a schedule for flowing through the EDFIT reserve but that nothing in that section suggests that something less than the entire reserve should [not][1] ultimately be flowed through to ratepayers. Accordingly, these proposed regulations retain the rule of the 2003 proposed regulations, with the effective date changes described below, for generation assets and extend the application of the rule to all other public utility property.**

Accordingly, for EDFIT, AVH and HCHE agree with the conclusions and the rationale as stated in the 2003 and 2005 Proposed Regulations, with the exception of the effective date changes, which will be addressed in the next section of these comments.

For the ADITC, however, the new Proposed Regulation substantially changed the rationale from that relied on in the 2003 Proposed Regulation and the resulting conclusion. AVH and HCHE believe the rationale in the new Proposed Regulation is flawed and that the IRS and Treasury should reinstate both the rationale and conclusion from the 2003 Proposed Regulation before the Proposed Regulation becomes final.

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[1] The proposed regulation used the same language as the 2003 proposed regulation, but appears to have inadvertently left out the word "not." Obviously, this should be corrected in a final regulation.

For the ADITC, the new Proposed Regulation correctly states that the ADITC lowered the utility's actual tax expense when the asset was purchased. However, under the former section 46(f) of the IRC, Congress specified that the subsidy be shared between the utility and its ratepayers in one of two ways, either one of which could be elected by the utility. One way was as a reduction to the investment in the assets included in rate base, thus providing the ratepayers the carrying charge value of the unamortized ADITC over the regulatory lives of the assets. The other way was as a reduction to income tax expense through an amortization of the ADITC amount over the regulatory lives of the assets, thus providing the ratepayers the principal value of the ADITC. All three utilities in Texas elected the second option.

The Proposed Regulation incorrectly states that "The underlying policy of former section 46(f) is to share this subsidy between ratepayers and utilities in proportion to their respective contributions to the purchase price." This is not correct. The underlying policy was to promote capital investment by allowing the utilities to retain either the carrying charge benefit of the ADITC or the discounted value of the principal, with the ratepayers receiving either the discounted value of the principal (through amortization to expense over the regulatory lives of the assets) or the carrying charge benefit of the ADITC, respectively. Regardless of the actual underlying policy of former section 46(f), the ratepayers were responsible for the entirety of the costs associated with purchase price, which included the obligation to pay for the carrying charges on the undepreciated cost included in rate base and to pay for the depreciation expense based on the purchase price. The Congressional intent to share the value of the subsidy had nothing to do with the respective contributions to the purchase price; if it did, then there would have been no sharing whatsoever with the utility and the ratepayers would have been allowed to receive the full value of the ADITC flow-through, including the carrying charges through a reduction in rate base and the amortization credit consistent with the ratepayers' obligation to pay the entirety of the purchase price. In the proceedings in Texas, the PUCT provided ratepayers only the discounted value of the ADITC, which it used as a reduction to stranded costs.

The Proposed Regulation also incorrectly states as a premise that "In the case of a deregulated asset, the contribution of ratepayers can be appropriately measured by the ratemaking depreciation expense they are charged with respect to the asset and any additional stranded cost that the utility is permitted to recover with respect to the asset after its deregulation." Unfortunately, this premise is incorrect and ignores the fact that someone still remains responsible for the costs that are considered after deregulation to be non-stranded (market) in addition to the stranded costs remaining after the non-stranded portion is subtracted. The only parties that can provide this non-stranded cost recovery continue to be the ratepayers, although they now must pay for this portion of the costs of the generation assets to a party other than the utility.

In the case of TNMP and TCC, the utility retained the value of the non-stranded ADITC as well as the stranded ADITC; neither amount was transferred to the purchasers of their generation assets. All else equal, the purchasers paid more for the generation assets and

thus, will necessarily need to recover more from ratepayers, than if the ADITC had been transferred to the purchaser. In the case of CNP, it is likely that the purchaser of the Company that owned its generation assets assigned no value to the ADITC and instead elected to step up the tax basis of the generation assets acquired. In the case of CNP as well as TNMP and TCC, there will be no flow-through to ratepayers of the ADITC on the non-stranded portion unless the entirety of the ADITC is allocated to the ratepayers as a reduction to stranded cost recovery. Thus, the distinction assumed in the Proposed Regulation, based on the premise that the non-stranded portion of the cost is no longer borne by ratepayers, simply is incorrect. As such, the rationale in the Proposed Regulation does not support an allocation between non-stranded and stranded ADITC or the conclusion that ratepayers be allocated only the stranded cost portion of the ADITC.

In addition to the flawed rationale and premises previously addressed, the Proposed Regulation also incorrectly assumes that the IRS has consistently held in private letter rulings that the flow-through of the EDFIT and ADITC reserves associated with an asset after the asset's disposition would cause a normalization violation. This appears to be the rationale for the imposition of normalization violations as the default result, subject to the limited effective date changes in the new Proposed Regulations. As a factual matter, the private letter rulings constitute a mixed result and, in any event, to the extent that they do support the conclusion of normalization violations under similar factual bases, the Proposed Regulation itself rejects the prior letter rulings as the basis for this Proposed Regulation. As such, it is illogical to define the default result as a normalization violation. Instead, the default result should be no normalization violation as long as the flow-through otherwise meets the criteria established in the Final Regulation.

In 1999, the United Illuminating Company (UI) sought a PLR with the same factual bases addressed in the Proposed Regulation. Unlike other utilities, UI sought a PLR favorable to ratepayers and argued in its request and also at its conference of right that the sale of public utility property simply "accelerated" the regulatory life of the EDFIT and ADITC. In that manner, these reserve amounts qualified for flow-through to ratepayers in their entirety on the sale date despite the fact that after the sale date the property was no longer public utility property in the hands of the third party purchasers. Mr. James Warren, presently of Thelen Reid and Priest, represented UI in its request and developed and supported the arguments reflected in the UI request and in the conference of right presentation. Mr. Lane Kollen of J. Kennedy and Asscociates, Inc., on behalf of industrial clients in Connecticut, worked with Mr. Warren in drafting the UI request and in the preparation of the presentation at the conference of right and participated telephonically in the conference of right. Attachment 1 to these comments is a copy of the UI request for PLR, which includes the rationale why the flow-through of EDFIT and ADITC as a reduction to stranded cost recovery do not constitute normalization violations. Attachment 2 to these comments is a copy of the outline used for the presentation made by Mr. Warren to the IRS at the UI conference of right.[2]

[2] The request for PLR and the outline of the presentation at the UI conference of right was produced by Mr. Warren in the TNMP stranded cost true-up proceeding before the PUCT in Docket No. 29206 and is a publicly available document.

Effective Date Provisions Negate the Central Conclusions on Which the Proposed Regulation Is Based

The effective date provisions in the Proposed Regulation, when coupled with the default result of normalization violations, negate the rationale and the conclusions on which the proposed regulations are based. These provisions of the Proposed Regulation will result in the utilities in Texas retaining the entirety of the EDFIT and ADITC despite the conclusions reached in the Proposed Regulation that all the EDFIT and a portion of the ADITC may be flowed-through to ratepayers without resulting in normalization violations.

If the rationale stated for the entirety of the EDFIT and the stranded cost portion of the ADITC in the Proposed Regulation is correct, then there should not be normalization violations simply because the flow-through subsequent to deregulation or other disposition either has not been commenced or completed by the effective dates.

The effective dates are tied to publication dates of either the 2003 Proposed Regulation or the new Proposed Regulation. Publication dates should not drive the results; the underlying rationale should drive the results. The 2003 Proposed Regulation explicitly recognized that publication dates should not drive the results and provided that the utility could make an election to retroactively apply the Proposed Regulation and avoid normalization violations. The new Proposed Regulation provides no rationale for the changes in the effective date provisions compared to the 2003 Proposed Regulation. Indeed, there is no rationale for such a change.

The Proposed Regulation appears to allow flow-through only if it occurs during the period March 5, 2003, the day after the publication date of the 2003 Proposed Regulation through the "earlier of the last date on which the utility's rates are determined under the rate order in effect on December 21, 2005, or December 21, 2007." This effective date provision is terribly confusing, but it would appear that the flow-through must occur between March 5, 2003 and December 21, 2005 or otherwise there will be normalization violations. Obviously, this negates any flow-through to ratepayers by those utilities which do not yet have a final rate order in effect to recover stranded costs, such as TNMP and TCC and for any utilities that have not yet completed recovery of their stranded costs. Furthermore, that is an impossibly short window to allow flow-through of the EDFIT and ADITC to ratepayers of utilities that already have final rate orders and almost guarantees that no flow-through or no additional flow-through will be allowed. Thus, the rationale and the conclusions stated in the Proposed Regulation are frustrated, ratepayers lose the tax benefits that were generated by the very investment costs for which they remain responsible, and the utilities reap unintended and unjustified windfalls.

The effective date provisions in the Proposed Regulation should be modified to allow an election for retroactive application and to allow flow-through of the EDFIT and ADITC reserves in the pending Texas proceedings over the same period as stranded cost recovery is allowed. Otherwise, the effective date provisions in the Proposed Regulation will

eliminate any real-world effective flow-through of any EDFIT or ADITC tax benefits altogether in the pending and prospective Texas proceedings in which stranded cost rates will be established, a result that is inequitable and does not appear to be intended.

Conclusion

The Proposed Regulation should be modified to allow the flow-through to ratepayers of the entirety of the EDFIT and ADITC reserves in the pending and prospective as well as the completed stranded cost proceedings in Texas. In addition, the effective dates in the Proposed Regulation should be modified to allow an election for retroactive application and to allow flow-through of the EDFIT and ADITC reserves in the pending Texas proceedings over the same period as stranded cost recovery is allowed.