IRS Transcripts

Transcript of IRS April 5, 2006, Hearing on Proposed Rules (REG-104385-01) on Return of Normalization Reserves to Ratepayers

IRC Section 168
Document Date: April 5, 2006

PANEL (IRS):

WILLIAM P. O'SHEA DEPUTY ASSOCIATE CHIEF COUNSEL, OFFICE OF ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES)

CHRISTOPHER T. KELLY, SPECIAL ASSISTANT TO THE ASSOCIATE CHIEF COUNSEL, OFFICE OF ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES)

PETER C. FRIEDMAN, SENIOR TECHNICIAN REVIEWER, OFFICE OF ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES)

DAVID SELIG, ATTORNEY-ADVISOR, OFFICE OF ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES)

PANEL (TREASURY DEPARTMENT):

JOHN PARCELL, ACTING DEPUTY TAX LEGISLATIVE COUNSEL, OFFICE OF TAX POLICY

SPEAKERS:

STEVEN CADWALLADER, CONNECTICUT DEPARTMENT OF PUBLIC UTILITY CONTROL

ALAN R. LOVINGER, OFFICE OF THE ATTORNEY GENERAL FOR THE DISTRICT OF COLUMBIA

BENNETT RUSHKOFF, OFFICE OF THE ATTORNEY GENERAL FOR THE DISTRICT OF COLUMBIA

LANE KOLLEN, ALLIANCE FOR THE VALLEY HEALTHCARE AND HOUSTON COUNCIL FOR HEALTH AND EDUCATION

MR. O'SHEA: Hello? OK, that's on. We might as well get started; I've got 10:00. This is the hearing for the proposed normalization regulation, and we have three people testifying today. I'll introduce the panels. On my far left is Dave Selig; he's an attorney in passthroughs and special industries. He's the principal author of the reg. To his right is Peter Friedman; he's in passthroughs and special industries and the reviewer on the regulation. To his right, in the middle here, is Christopher Kelly; he's on the associate chief counsel of pass-through and special industries staff. To my immediate left is John Parcell; he's the deputy tax legislative counsel over at the Office of Tax Policy at Treasury. And I'm Bill O'Shea; I'm the

deputy associate chief counsel, pass-through and special industries, a rather long time. With those introductions, we might as well just get started.

Our first speaker listed is from the Connecticut Department of Public Utilities. It's Steven Cadwallader. Is he here?

MR. CADWALLADER: Cad-walla-der. Yes.

MR. O'SHEA: The speakers get 10 minutes. Some of the speakers have submitted outlines, and it actually has them broken down by minute, but we'll stick pretty much with the 10 minutes, if we can.

MR. CADWALLADER: Good morning, gentlemen. My name is Steven Cadwallader. I'm a chief of utility regulation with the Connecticut Department of Public Utility Control. On behalf of the Connecticut DPC, I would like to thank the Internal Revenue Service of the Department of Treasury for requesting comments and holding this public hearing on its proposed regulations published December 21, 2005, regarding the application of normalization accounting rules to public utilities, more specifically, how those rules should be applied to balances of excess deferred income taxes and accumulated investment tax credits associated with assets that have ceased to be public utility property.

Our department has taken the rather extraordinary step, for us, of filing written comments with the IRS several weeks ago and presenting oral comments today on these proposed regulations. We have taken this action because the proposed regulation would lead to an injustice and poses potential significant harm on Connecticut rate payers.

In their totality, the proposed regulations signal a revised interpretation of the existing normalization rules, and characterization of the prior interpretation and a statement of intention to apply the prior interpretation to assets that ceased to be public utility property before March 5th, 2003.

For us, the issue is very simple: whether the prior interpretation, which was limited in scope, should have universal applicability. The regulations as proposed would have the prior interpretation applied to all assets that ceased to be public utility property before March 5th, 2003, effectively locking for those assets an interpretation of the normalization rules that the IRS itself acknowledges was in error. The Connecticut DPUC believes very strongly that the prior interpretation should not be applied to any assets, regardless of when they ceased to be public utility property. We believe this for the following primary reasons:

The prior interpretation was wrong. The IRS, in its notice of proposed regulations published December 21, 2005, characterized its prior interpretation of the normalization rules as being that flow-through of excess deferred income taxes and accumulated deferred investment tax credit reserves is permitted only over an asset's regulatory life, and when that life is terminated by regulation, no further flow-through is permitted--rather, by deregulation, no further flow-through is permitted.

However, as described in more detail in our written comments, such an interpretation is not derived from the language of the rules themselves, and works to thwart congressional intent, the expectations of rate payers, utility commissions and utilities, and is contrary to the historic treatment afforded the reserves while the assets were deregulated, and also the treatment afforded companies in competitive industries.

Indeed, the only way the IRS can arrive at its prior interpretation regarding excess deferred income taxes is to create from whole cloth its own normalization restriction requiring that flow-through of excess deferred income tax reserves be compilations, while a physical asset is being depreciated for regulatory purposes. This extra IRS-imposed restriction is nowhere to be found in Section 203(e) of the Tax Reform Act of 1986, which addresses excess deferred income taxes and their reserves. The Section only limits the speed at which the reserve can be flowed through, but sets no deadline as to when that flow-through must be accomplished.

With regard to asset sale, the reverse (of ?) a full aggregate timing differences associated with an asset completely fulfills the normalization requirements regarding excess deferred income tax reserves so that it can be disposed of as regulators see fit. Any other interpretation, such as the prior interpretation, does not square with the plain language of the rules and thwarts congressional intent.

On the very basic tenets of fairness and justice, the prior interpretation fails. It serves to restrict the rightful return of rate payer-funded reserves to rate payers, creating a situation where rate payer funds are likely to be usurped and granted as a windfall to utility shareholders. Such a taking of rate payer funds, not by law, but by mistaken interpretation, is unconstitutional and should not be imposed.

The notice goes on to state that after further consideration, the IRS and Treasury have concluded that the normalization rules do not permit or preclude flow-through after an asset is deregulated. Note that the IRS and the Treasury are not stating that the rules are wrong and that they propose to change them, but rather that their prior interpretation was wrong and that they did not appropriately apply existing rules.

Indeed, the proposed regulations do not change one word of the existing rules; instead, they formally signal a change in the IRS's interpretation of those existing rules. This changed interpretation correctly drops the IRS-imposed restriction on excess deferred income tax reserves, allowing these reserves to be flowed through after an asset is no longer public utility property. The changed interpretation also allows accumulated deferred income tax credit reserves, in some cases, to be flowed through after deregulation. The modifications in the IRS's interpretation brings the manner in which the normalization rules will be applied in line with the rules as written, congressional intent, the expectations of rate payers, utility commissions, and utilities, and the historic treatment afforded the reserves while the assets were regulated, and the treatment afforded companies in competitive industries. The changed interpretation restores, in practice, the fairness and justice of the rules by facilitating the return of rate payer-funded reserves to rate payers, while keeping utilities whole with regard to their actual costs, including taxes.

Given that the prior interpretation was in error and that the changed interpretation more accurately reflects the language of the rules and congressional intent, there is no logical basis for concluding, as the proposed regulations do, that the prior interpretation should be controlling until March 4th, 2003. by this conclusion, the IRS is proposing to discard the actual rules and replace them with its interpretation, saying, in effect, that their interpretation was the rules, and now that their interpretation has changed, the rules are changed. If this were in fact the case, then quite clearly, earlier transactions should be considered under the rules then in effect; but this is not the case. The rules have not changed. If the rules were misapplied in some cases, then those cases may need to be revisited, but in no event should the misapplication be visited upon all pending cases from an earlier period. The same rules that are in effect now were in effect then, and the outcome should be the same. It is never too late to right a wrong and to see that justice is served. Better to bring about a delayed correction than to institutionalize an injustice.

I'm reminded of a story about Abraham Lincoln that recounts the time when he argued two cases before the same judge on the same day. In the morning, he argues the case one way and the judge rules in his favor. In the afternoon, he argues a very similar case on the other side of the issue. The judge objects, saying, "How can you argue this side of the case this afternoon, when this morning you argued the opposite side of the case?" And Abe Lincoln responds, "Between this morning and this afternoon, I got smarter." And that's what's happened here, between its private letter rulings and the proposed regulations, the IRS got smarter, and just as they would have been unreasonable for the judge in the story to state that all pending cases submitted prior to the morning case would be decided the way the morning case was decided and all cases submitted after the afternoon case would be decided on the basis articulated by a smarter Abe Lincoln, it is also unreasonable for the IRS to categorically declare that all transactions prior to March 5th, 2003, will be decided using the prior incorrect interpretation. The correct result is that all cases should get the benefit of an appropriate interpretation of law.

Now, we understand that this has been a long process for the IRS, and that as early as the late 1980s, the

IRS began addressing the application of normalization rules to deregulated assets, and we sympathize with the IRS's desire to finalize how that's done. But by its latest proposal, the IRS is proposing a compromise granting utility shareholders the windfall of retaining rate payer-funded excess deferred income taxes and accumulated deferred income tax credit reserves for all assets that ceased to be public utility property prior to March 5th, 2003, and only treating rate payers fairly for assets that were deregulated after that date.

This split-the-baby-in-two approach is not supported by law, and is fair to no one, because it denies rate payers a significant amount of the reserves that they funded and are entitled to, and because it unfairly enriches utility shareholders of those amounts of reserves. It is important to remember that through the wisdom of Solomon, the baby was not split in two; rather, he threatened to split the baby in two to solicit the reactions that would enable him to determine who the baby should be given to. Splitting the baby in two was not the right response back then; it's not the right response here. Rate payers should fairly and justly treated regarding the excess deferred income tax and accumulated deferred income tax credit reserves, and the normalization rules should be applied consistent with the language of the rules and congressional intent.

In closing, I'd again like to thank you for this opportunity to be heard and urge the IRS and Treasury to do the right thing by applying the correct interpretation of the normalization rules to all assets, regardless of when they ceased to be public utility property.

I'd be happy to take any questions at this time.

MR. O'SHEA: Are there any questions?

MR. PARCELL: What were the expectations of utilities and PUCs prior to 2003 concerning the flow-through of the excess reserves?

MR. CADWALLADER: I think from the law, the expectation was, for the Connecticut UPC, that those reserves would be return to rate payers upon the sale of an asset.

MR. PARCELL: Not withstanding the PLRs that had been issued?

MR. CADWALLADER: Well, to us, those PLRs did not apply. They weren't precedent; they were specific to particular rate payers, and in most instances, those circumstances did not match the circumstances in Connecticut.

MR. PARCELL: Well, how so?

MR. CADWALLADER: They had particular circumstances surrounding them, such as, they were specific to particular instances that had differences from the situation in Connecticut, where our Legislature required the deregulation of these assets, and none of the private letter rulings matched that.

MR. PARCELL: But was that material to the holding in the PLR, the fact that this was a statutory mandate?

MR. CADWALLADER: Well, not being party to the PLR process, we didn't know the particulars. The plain reading of the language states that there is a limit as to how fast you can flow these reserves back, but it says nothing about there being a requirement to flow those back prior to the end of a public utility life of a regulatory asset.

MR. PARCELL: But I thought the PLRs said pretty clearly you couldn't flow it back after the asset was

removed from rate base?

MR. CADWALLADER: Not being a party to those PLRs and being involve din the process, we didn't know what kind of push-backs were given when those responses were given, and didn't have an opportunity to voice our opinion. And that's one of our objections, because there was no public forum, such as there's been now, with regard to those PLRs, no opportunity for us and others to voice their dissent to those PLRs.

MR. PARCELL: So I take it you did deregulate the assets prior to 2003, and required flow-through ...

MR. CADWALLADER: Actually, we put those on hold, pending--we had requests for the IRS to rule on those, what happened to those reserves, with the expectation that they would be allowed back to rate payers.

MR. PARCELL: OK.

MR. O'SHEA: OK. Thank you very much.

MR. CADWALLADER: Thank you.

MR. O'SHEA: Our next speaker is from the Office of the Attorney General for the District of Columbia, and there are two people listed--Bennett Rushkoff and Alan Lovinger.

MR. RUSHKOFF: Good morning. My name is Bennett Rushkoff. I am chief of the Consumer and Trade Protection Section in the Office of the Attorney General for the District of Columbia. The attorney general very much appreciates your making available this opportunity for us to comment.

Our office represents the interests of the District of Columbia before the District of Columbia Public Service Commission. The District of Columbia government is a major consumer of utility services and administers utility assistance programs for low-income residents. Our interest in this rulemaking stems from the effect it could have on a proceeding still pending before our public service commission to determine the proper allocation of divestiture proceeds generated by the sale of PEPCO's electricity generating assets. Our specific concerns which is similar to that just expressed by the prior speaker, is that the IRS's new regulations could have the unintended consequence of preventing our public service commission from allocating these proceeds in a way that is fair to rate payers and consistent with a prior settlement agreement reached with PEPCO.

I would like to introduce Alan Lovinger, a consultant to the District of Columbia government, and he has been an expert witness for us in the proceeding before the public service commission. Thank you.

MR. LOVINGER: Good morning. My name is Alan R. Lovinger, and I'm currently a vice president partner in an energy consulting firm by the name of Brown, Williams, Moorhead and Quinn. In my former career, the federal government employed me for 31 years, the first seven years as an internal revenue agent, in the final 24 years as a utility regulator at the Federal Energy Regulatory Commission Office of Pipeline Rates.

One of my assignments at FERC was to implement a policy change from flow-through tax benefits to full tax normalization and to coordinate this implementation with IRS tax normalization regulations. I soon discovered that FERC's accounting requirements for financial reporting purposes did not provide the necessary book depreciation record for individual depreciable assets included in a pipeline transmission--transmission and storage functions. Thus, my proposed method of achieving full normalization for regulatory purposes was challenged both by utilities and by their outside audit firms. The

representatives cited private letter rulings at the time and passages from the regulations Sections 167 and 168 that, in their opinion, showed that my proposed method of achieving full normalization would cause a violation of IRS normalization rules. After several years of litigation at FERC and settlement negotiations with utilities and their representatives, FERC implemented the policies that I had proposed for full interparity tax normalization.

Next, I met with Treasury and IRS personnel to help them understand that the gas pipeline industry, as regulated by FERC, was not capable of fully complying with the IRS income tax normalization requirements. After numerous discussions with Treasury, there was a recognition that FERC required a composite method of book depreciation for the entire function, rather than a method based on individual asset records for all assets included within a particular function. After numerous discussions with Treasury and IRS, I think there became an understanding that the normalization regulations did not apply to FERC-regulated utilities.

Treasury then issued revenue rulings approving what is now known as the "South Georgia method" of tax normalization, and I think the South Georgia method is mentioned quite often in the normalization regulations and is used industrywide, even beyond the gas pipeline industry.

After the tax reform of 1986 lowered the federal corporate income tax rate from 40 (percent) to 34 percent--from 40 to 34 percent--the accumulated deferred income tax, EDFIT, generally went from a deficiency to an excess status, indicating that rate payers had paid more than was needed to meet the utilities' future tax liability. The goal of the regulatory agencies, including FERC, was to return the excess to rate payers immediately. However the Treasury proposed an average rate assumption method that required the excess to be flowed through to rate payers ratably over the remaining life of the regulatory assets, giving rise to the excess EDFIT.

For FERC-regulated utilities, ARAM could not be properly implemented, due to the insufficient financial depreciation records. Through my efforts, FERC proposed an alternative method of returning EDFIT ratably, which was called the "reverse South Georgia method." The Treasury, soon after, provided exemptions to ARAM rules, permitting the reverse South Georgia method to be used for those utilities that had insufficient records to implement ARAM.

I reviewed this history with you today for two reasons, first, to show that when there was a deficiency in the deferred federal income tax due to past regulatory flow-through policies, rate payers were called upon to pay rates that were sufficient to fully fund the accumulated deferred federal income tax balance. Second, to show that Treasury, in considering normalization rules, has sought to accommodate the needs of regulatory agencies.

And I have worked with the normalization rules for over 30 years. Over that period, I have found that for the most part, the regulations are difficult to understand and difficult to apply to regulatory situations--and I'm speaking, more or less, from a regulator, not a tax expert-- and I think the rules were supposed to apply to, you know, for regulated situations, and I have to tell you, it is very, very difficult to understand these regs and apply them.

I therefore understand how the private letter rulings that were issued prior to March 5th, 2003, could conclude incorrectly that normalization violations would occur if EDFIT balances were permitted to flow through to rate payers. These rulings missed two key points, I believe. One is that ARAM clearly indicated that EDFIT was rate payers' money; and two, that normalization should not apply when assets cease being public utility property. I am here to point out the injustice of making the 2005 proposed regulations inapplicable under any circumstances to transactions that occurred prior to March 5th, 2003. A blanket exception to flow through for public utility property that became deregulated prior to March 5th, 2003, would prevent the Public Service Commission of the District of Columbia from ordering a fair allocation of the divestiture proceeds resulting from the sale of electric generating assets by the Potomac Electric Power Company, PEPCO.

PSC initiated formal case 945 to investigate electric service market competition and regulatory practice in the District of Columbia. In the course of that proceeding, the PSC approved a 1999 settlement with PEPCO that called for the divestiture of electric generating assets and the sharing of divestiture profits with rate payers. Under that agreement, EDFIT attributable to the generating assets sold by PEPCO is supposed to flow to the benefit of rate payers. Only after PEPCO became aware of IRS's private letter ruling did it seek to remove EDFIT from the proceeds to be shared with rate payers. On October 10th, 2001, the PSC ordered that further proceedings be placed on hold with respect to PEPCO's divestiture-sharing plan until Treasury issued final regulations.

The clearest example of the unfairness that could result from the blanket prohibition against applying the IRS proposed regulations to any property deregulated before March 5th is the windfall that PEPCO shareholders would receive at the expense of PEPCO rate payers. Funds clearly recognized as rate payers' funds by regulatory agencies, as well as Treasury's own regulations, should not be retained by utilities simply because the utility's assets have been sold.

In the past, Treasury has shown flexibility on developing normalization rules, as witnessed by the exceptions it created for South Georgia and the reverse South Georgia method. Clearly, flexibility is called for here, where a broad prohibition against retroactive application would prevent the PSC from deciding formal case 945 fairly and consistently with the 1999 settlement.

The only reason proposed by the IRS for not allowing retroactive application is that it should not be exercised in a manner that impairs existing agreements between utilities and the regulators. But the goal of protecting the final agreement between utilities and regulators would not be served if IRS were to dictate an unfair, unforeseen outcome for regulatory issues that have yet to be resolved. Given that the EDFIT issue is still pending before the PSC, the PSC should be allowed to opt for results that are most consistent with the parties' 1999 agreement and with IRS's own analysis in 2005 regulations, as a proper flow-through of EDFIT reserves associated with a deregulated utility property.

MR. O'SHEA: I'm afraid your time is up. That sounds like a good spot to end.

MR. LOVINGER: I am finished. (Laughter.) That is a good spot.

MR. O'SHEA: Are there any questions?

MR. PARCELL: Yes. Is the EDFIT issue the only issue relating to the deregulation --

MR. LOVINGER: No, we were also with the investment tax credit. However, the logic in the 2005 proposed regulations seemed to be appropriate. Here, the excess deferred income tax is contributed by the rate payer; however, the investment tax credit is not contributed by a rate payer, and we don't--we think that's a correct interpretation. So we're only seeking--the D.C. government's only seeking for the excess deferred income taxes.

MR. PARCELL: OK, but --

MR. LOVINGER: But we would not be opposed --

MR. PARCELL: Right. I take from the tenor of your comments that this is not a stranded cost case, that there --

MR. LOVINGER: No. We don't--it's not a stranded cost. There --

MR. PARCELL: And so there was a profit on the sale of the --

MR. LOVINGER: Yeah, there was a substantial profit.

MR. PARCELL: And how was that profit distributed, taking the EDFIT out of it?

MR. LOVINGER: Well, it's--it was, you know, there was an agreed amount, anything above like 100 million dollars was to go -- 50/50. I don't know the exact terms, but it was set up so that it was a reasonable sharing between the utility and rate payers.

MR. PARCELL: And is that still open, depending on how the EDFIT issue is resolved?

MR. LOVINGER: Yes. Yes, it is.

MR. PARCELL: Thank you.

MR. O'SHEA: OK. Thank you very much.

Our final speaker today is from the Alliance for Valley Health Care and Houston Council for Health and Education, and it's Lane Kollen. Did I pronounce that right?

MR. KOLLEN: It's "Kollen".

MR. O'SHEA: Kollen.

MR. KOLLEN: Yes.

MR. O'SHEA: Go ahead.

MR. KOLLEN: Does everybody have a copy of my written comments?

MR. O'SHEA: Yes.

MR. KOLLEN: OK. I would like to, before I start with my oral comments here, refer you to the requester for private letter ruling that is attached as an attachment to my written comments. Mr. Parcell, you asked some questions of an earlier speaker with respect to the IRS private letter rulings and whether or not there was some consistency there in terms of flow-through and normalization violations, and I think you'll see that there's litany of authorities contained in that request for private letter ruling, on behalf of United Illuminating, that will give you a somewhat different picture, that there is a mixed bag out there that is not unilaterally a finding of normalization violations. So I would urge you to take a look at that.

The two groups that I represent are rate payers, hospitals, universities, colleges and other health care facilities that take service on two utility systems in Texas. These proposed regulations will dramatically impact the rates that these customers will pay. This is a stranded cost situation. There are--the two utilities are AEP Texas Central and Center Point Houston Electric. There's a third utility, Texas-New Mexico Power Company, that will be impacted as well in Texas. All three have received orders from the PUCT finding that the EDFIT and the ADITC should be flowed through to rate payers in conjunction with the recovery of stranded costs in all three instances. Only in the case of Center Point Houston Electric

has the PUCT--and that is the Public Utility Commission of Texas--determined how the amounts will actually be flowed through to rate payers as a reduction to stranded costs.

In that case, the PUCT provided the entirety of the EDFIT to rate payers and allocated the ADITC between Center Point and the rate payers by discounting the ADFIT balance over the recovery period as a reduction to stranded costs. In this manner, Center Point retained the carrying charge value of the ADITC, consistent with traditional rate making practice in Texas, and the rate payers received the present-value equivalent of the ADITC amortization over the stranded cost recovery period, also consistent with traditional rate making practice in Texas.

It is likely, based on the Center Point precedent that the PUCT will issue similar orders for AEP Texas Central Company and Texas-New Mexico Power, flowing through the entirety of the EDFIT tax benefits to rate payers and the discounted value of the ADITC. Consequently, through the orders issued in Texas, there are existing agreements on these tax benefits, although the PUCT has issued orders establishing rates only for CNP at this point, because the rates are yet pending for Texas-New Mexico Power and Texas Central. The amount of EDFIT and ADITC that is at stake for these three utilities on a revenue-requirement basis, which is the way you look at it for rate-making purposes, is nearly $600 million. So you can see why my clients have an interest in this.

The proposed rates, if they become final absent modification, will ensure that the 581 million dollars, the nearly $600 million in these tax benefits, cannot be flowed through to rate payers, a result that is not consistent with the legislative intent, tying the flow-through of these tax benefits to stranded-cost recovery.

Although the conceptual discussion of the proposed regulation supports the full flow-through of the EDFIT and the partial flow through of ADITC, the effective date provisions negate those critical conclusions.

So we're asking for two things.

First, we are asking that you allow the full flow-through of ADIC on a basis economically equivalent to the mandatory sharing of this tax benefit under the former Section 46(f), and that is where if you're a method two election company where the amortization of the ITC goes to the ratepayers but the utility retains the carrying charge value, if you discount the amortization to a net present value, which is what the Texas commission has done, that's the economic equivalent of the 46--of former Section 46(f)(2) election.

And the second thing that we're asking you to do is allow the flow through to the ratepayers of the EDFIT and ITC over the life of the stranded cost recovery because in all three situations in Texas, there is stranded cost recovery. And these periods of time for the stranded cost recovery are likely to be in the neighborhood of 12 to 15 years.

So this is a regulatory life, and we think that it's appropriate to allow the flow through of the EDFIT and the ADITC over this regulatory life. And so we're asking you to take a very hard look at those effective date provisions, which I'll talk about briefly, to allow the flow through.

We agree with your rationale in the proposed regulation on the EDFIT, so I'd like to focus then on the ADITC.

We agree with the conceptual discussion of the ADITC. However, we disagree with the concept that the ADITC should be allocated between stranded cost and the non-stranded cost portion. This is something new that was introduced in the 2005 proposed regs compared to the 2003.

And according to the discussion in the proposed regs, this allocation, the allocation between stranded and non-stranded costs, is premised on the fact that there is some kind of cost sharing between ratepayers and the utility in terms of the recovery of the underlying assets. That simply isn't true. The ratepayers are

responsible for 100 percent of the cost of those assets. And therefore, unless there is some specific statutory limitation, such as the sharing pursuant to the former Section 46(f), it follows that 100 percent of the relevant portion of the ITC should be flowed through to the ratepayers.

With the ratepayers on the hook for 100 percent of the cost, it follows that the ITC should be allocated entirely to the ratepayers as well, no allocation between stranded and non-stranded. In the case of the Texas utilities, the relevant portion of the ADITC is the net present value of the future amortization. Again, that's because that's consistent with the former Section 46(f) and the method two election of all three of the utilities in the state.

Consequently, because of the commission's methodology, by discounting this amortization of the ITC, there already is an allocation consistent with congressional intent and consistent with the former Section 46(f). The utilities receive a carrying charge benefit and there is flow through of the amortization of ratepayers pursuant to the utility's method of election.

The proposed regulations disturb this statutory sharing relationship between the utilities and the amount that can be flowed through by superimposing another--and I would characterize this as a non-statutory allocation based on this stranded versus non-stranded cost delineation. Even if the IRS believes that this additional allocation should be superimposed on the process, then it should consider that ratepayers still are effectively paying 100 percent of the costs.

The distinction between stranded and non-stranded costs I believe is artificial because the ratepayers will pay both the stranded and the non-stranded costs; it's just a question in what manner will they pay them. The stranded costs will be paid directly through a surcharge. The non-stranded portion will still be paid, but it'll be paid to a third party.

So conceptually there should be no distinction, in my opinion, between the EDFIT and the ITC in terms of some allocation between the stranded and non-stranded costs. The distinction is related only to the statutory prohibition against flowing through to the ratepayers both the return of and on the ADITC.

One thing I'd like you to consider as well is that when there is a sale or there is a deregulation--and this is something you'll see discussed in the request for private letter ruling attached to my written comments--is that at the time of deregulation or sale, there's a compression of the regulatory life. And at that point in time--and that's consistent with some of the private letter rulings and some of the other guidance issued by the IRS, so I really urge you to take a strong look at that. And that them allows the normalization rules not to be violated as long as there's a cost relationship. If the ratepayers are paying for the cost, then the regulatory life should be the determinant, whether it's compressed to an immediate regulatory life or whether it's compressed to like a 14-year stranded cost recovery regulatory life.

And finally I'd like to address the effective dates of the provisions of the proposed regulations. Essentially, there's a retroactive--retroactivity provision that forces every utility that has not--where the property has not been deregulated after March of 2005--I'm sorry, December of 2005--then it is a normalization violation. I don't understand that. I think that's inappropriate. I think that the language that precedes it that says that the intent is not to disturb existing agreements, which would include rate orders in my opinion, you should not then disturb that by then saying anything that went before this effective date is necessarily a normalization violation and somehow would need to be remedied.

You're affecting quite a few utilities, not only the two that--on the groups that I represent. So I really would urge you to take a strong look at those effective date provisions because they essentially negate everything that you've concluded. The central findings that are articulated in the proposed regulations are negated. So I would just ask you to review that and remedy that situation.

MR. O'SHEA: You're time is up, but that's a good point.

MR. KOLLEN: Yes, it is. Thank you very much.

MR. O'SHEA: OK. Questions?

MR. PARCELL: Yeah. I really don't understand your point about the ratepayers being responsible for 100 percent of the cost of an asset even after deregulation.

MR. KOLLEN: Yes, essentially there are two places where the utility recovers its costs. It can recover the cost at the sale of the asset, which is the market value. So that accelerated that portion of the recovery of the cost. The ratepayer still is responsible for that portion of the cost because it will pay a market value to a third party. So even though the entity has changed, the fact is the utility has recovered its costs. That regulatory life has been collapsed to today, at the date of the sale or the deregulation, either situation. So the ratepayers still are on the hook for that cost. They're going to pay that cost to a third party, but now the utility has already realized that cost through the market value.

The stranded cost, then, is the difference between the book value and the market value that the utility already received. So if you look at the total cost which the rate payer is responsible for as consisting of two components--the market value, which is received by the utility at the time that it sells the assets and therefore it collapses that regulatory life to zero days--and I think then that the ITC or the EDFIT associated with that market piece or that non-stranded piece is still a cost recovery from the ratepayers--and then you have a stranded piece, the difference between the book value and the market value, which the ratepayers will pay through a surcharge. But nevertheless, the ratepayers will still pay 100 percent of those costs.

MR. PARCELL: So is the logic to your position that, you know, if an independent power producer placed a generating plant in service today, and there were still an investment credit available today, that that credit should be flowed through to whoever bought its electricity?

MR. KOLLEN: No, I don't think so because in that situation, you don't have a cost-based utility. It didn't start out as a cost-based utility. You have--in the case of the utilities in Texas and the other utilities that I'm familiar with, including United Illuminating and Connecticut Power & Light--because I represented clients in the drafting of that United Illuminating request for private letter ruling, so I've addressed this issue around the country in many, many proceedings.

The situation with a merchant generator is that it's always been a market-based type of pricing. It never has been tied directly to cost. Whereas with the utility that then deregulates, the only reason that the ITC or the EDFIT are issues in terms of who gets those benefits is the fact that they were regulated assets and then were either sold or became deregulated in some other manner. So there's a clear distinction there.

And under utility ratemaking, it's a cost-based process and, you know, historically the regulators have used the tax benefits in conjunction with the other costs to determine what the ratepayers will pay. The normalization rules don't apply to a merchant generator like an IPP. They apply on to utilities, public utility property.

MR. PARCELL: So--OK. So the fact that it was regulated at one time is significant, and if the asset were sold the moment after it was placed in service, the entire ITC would still be flowed through to the ratepayers?

MR. KOLLEN: I think that would be a valid conclusion. And you know, for example, there is a private letter ruling where a utility entered in a sale lease back situation, and I don't recall whether the sale took place immediately after the asset was constructed by the utility or not, but that's not a particularly relevant point. The point is, is that the utility sold the asset and nevertheless received a private letter ruling from

the IRS--and that's cited in the United Illuminating request for private letter ruling attached to my written comments--that the ITC could be flowed back, flowed through to the ratepayers over the life of the lease. So I think that a directly on-point example.

MR. O'SHEA: It might have been recaptured.

MR. PARCELL: Well, there--yeah, there would have been recapture under the old ruling. That's correct.

MR. O'SHEA: Yeah.

So you're testifying that in your particular situation, when you deregulated, you present valued the benefits and flowed them through immediately?

MR. KOLLEN: No. What the PSET has done is it has calculated the net present value effective, the ITC amortization, which would be what the ratepayers would be flowed through under normal traditional regulation. But what it's done is let's say there's a 14-year regulatory life or stranded cost recovery period. It has taken the ITC balance and divided it by 14 to come up with the annual amounts of the amortization, and then discounted those, using the utility's cost of capital, and then used that as a reduction to the stranded cost recovery over a 14-year period.

So essentially it's providing an amortization without a return on the ITC over the recovery period, which is comparable to what would be required under the former Section 46(f)(2).

MR. O'SHEA: But is it your testimony that that would be inconsistent with our prior private letter rulings?

MR. KOLLEN: I don't believe it is inconsistent.

Now, you do have a mixed bag on your former private letter rulings. There are a couple, I think that were issued in 2000, that would say that any flow through of the ITC or the EDFIT to ratepayers is a normalization violation. But other ones would indicate that it would not be a normalization violation. And in any event, the proposed regulations indicate that you all have rethought that, and that you think that there's nothing in the 1986 Tax Act, Section 203(e), or, you know, the former Section 46(f) that would prohibit the flow through of these EDFIT or ITC amounts regardless or those private letter rulings.

But you do have a mixed bag, I'll readily acknowledge that.

MR. O'SHEA: OK. Any other questions? No? Thank you very much.

MR. KOLLEN: You're welcome. Thank you for the opportunity to speak today.

MR. O'SHEA: That concludes our hearing on the normalization regs. We appreciate everyone coming. Thanks.

Copyright (c) 2006 by The Bureau of National Affairs, Inc., Washington D.C.

The information transmitted is intended only for the person or entity to which it is addressed and may contain confidential and/or privileged material. Any review, retransmission, dissemination or other use of, or taking of any action in reliance upon, this information by persons or entities other than the intended recipient is prohibited. If you received this in error, please contact the sender and delete the material from any computer. PricewaterhouseCoopers LLP is a Delaware limited liability partnership.

Mark A Pyle/OR4/AEPIN
10/18/2011 07:21 AM

To Nancy J Napolitano/AEPIN@AEPIN
cc
bcc
Subject LK 1-10

----- Forwarded by Mark A Pyle/OR4/AEPIN on 10/18/2011 08:17 AM -----

Jeff C Broad/AEPIN
08/24/2006 05:11 PM

To DHedges@porterhedges.com, Don Moncrief/AEPIN@AEPIN, Gary W Moore/AEPIN@AEPIN, JAycock@porterhedges.com, Jeffrey B Bartsch/OR3/AEPIN@AEPIN, Jennifer L Jackson/AEPIN@AEPIN, jmt@ctw.com, jwarren@thelenreid.com, kmc@ctw.com, Larry W Brewer/AEPIN@AEPIN, Mark A Pyle/OR4/AEPIN@AEPIN, Randall W Hamlett/AEPIN@AEPIN, Rhonda C Ryan/AEPIN@AEPIN, Ronald K Ford/AEPIN@AEPIN, Teresa J Kraske/AEPIN@AEPIN, Timothy A King 'Legal Dept'/OR3/AEPIN@AEPIN, tucker-gerald@sbcglobal.net
cc
Subject TCC CTC Rebuttal to Intervenor Testimony

The intervenor testimony is out and after review the only issues appear to be tax normalization and refund period/rate design. There are no issues with the requested rate case expenses so no rebuttal testimony for Hedges or Tucker. Jim Warren is not available until Monday for a discussion on the tax issues. The call tomorrow (9/25) is canceled for all on this distribution except those needed to discuss with Jennifer and Don the refund period and rate design issue. Call in remains the same for those folks.

We will set up a call Monday for a discussion with Jim on the tax issues.

Thanks,
Jeff C. Broad
Regulatory Case Manager
American Electric Power
400 W. 15th St., Suite 1500
Austin, Tx. 78701
(512)481-4555 office
(512)439-9894 cell
(512)481-4588 fax
(770-Net)