GARY HERBERT.
Governor
GREG BELL
Lieutenant Governor

State of Utah
Department of Commerce
Division of Public Utilities

FRANCINE GIANI *Executive Director* | THAD LEVAR *Deputy Director* | PHILIP J. POWLICK *Director, Division of Public Utilities*

To: Public Service Commission

From: Division of Public Utilities
Philip Powlick, Director
Energy Section
Artie Powell, Manager
Matt Croft, Utility Analyst II

Date: July 28, 2010

Subject: Docket 10-035-38: RMP Application For An Accounting Order Regarding Post-Retirement Prescription Drug Coverage Tax Benefits

RECOMMENDATION: The Division recommends the Commission allow the Company to set up a regulatory asset for $4,667,606 million as opposed to the requested $6,498,185.

PROCEDURAL MATTTER: The Division and Office of Consumer Services (the "Office)" met with Rocky Mountain Power (the "Company") on July 7th, 2010 for a settlement conference. A settlement was not reached but it was agreed that the Division would file comments on July 28th and the Company would respond by August 19th. The hearing date remains at September 1st, 2010.

BACKGROUND:
Under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, companies can receive a federal subsidy to help offset the cost of post retirement prescription drug benefits offered to retirees. For approximately the last 5 years, and in accordance with US Generally Accepted Accounting Principles ("GAAP"), the Company has accrued Medicare expenses and subsidy income for book (GAAP) purposes. In subsequent years, the Company would pay the expense and receive the subsidy and therefore would effectively pay a net amount of Medicare expenses out-of-pocket. Even though the amount paid out-of-pocket was net of the subsidy, companies were allowed to deduct (for tax purposes) the full/gross Medicare expense accrued.

As a result of the Patient Protection and Affordable Care Act (the "Act"), and starting January 1 of 2013, the Company is now only allowed to deduct the net Medicare expense in the year it is paid. This means an amount of past Medicare expense accruals equal to the amount of the past accrued subsidy income will not be tax deductible. For the Company, this amount equals $25.5

million[1]. When multiplied by the effective tax rate of 37.951%, the resulting amount of $9.7 million represents the future tax benefits that are now lost. When allocated on a Utah basis and grossed up for taxes, the revenue requirement is approximately $6.5 million. This is the amount for which the Company seeks to set up a regulatory asset.

REVISION TO AND CLARIFICATION OF THE COMPANY'S APPLICATION:
The Company has made a significant revision to their application as well as a clarification of language used in the application. The revision came as a result of an update in information. The Company's original application proposed a Utah allocated regulatory asset of $7.7 million. This was based on information as of December 31, 2009. The Company subsequently revised this amount with information available through March 31, 2010. This revised amount resulted in the $6.5 million Utah allocated regulatory asset mentioned previously.

The clarification relates to language used in the Company's original application. One page 1 of it's application, the Company requests an accounting order to:

> record a regulatory asset associated with tax benefits **previously reflected in rates** that will no longer be realized for certain costs incurred for post-retirement prescription drug coverage as the result of the Patient Protection and Affordable Care Act (emphasis added).

In OCS data request 1.7, the Office requested information concerning these amounts that were "previously reflected in rates." The Company response to OCS 1.7 stated:

> The Company has not compiled this information because the Company **is not seeking a balancing account or the recovery of tax benefits previously reflected in prior rates**. The new law was not enacted or in effect when rates were previously set. Prior rates properly reflected that law in effect at the time (emphasis added).

GUIDELINES FOR ALLOWANCE OF DEFERRED ACCOUNTING TREATMENT
In previous proceedings, the Division has proposed several guidelines for determining if a particular application should be granted deferred accounting treatment. Based on those guidelines, the event under consideration should be unforeseen, specific, unusual, and material amongst other things. We find the change in the tax law to meet these criteria and therefore recommend that the Commission grant deferral. Although a deferral is recommended, the Division does recommend adjustments to the amount that is deferred. A general description of the accounting for the tax effects of the post retirement benefit expenses will now be discussed, followed by the basis for our proposed adjustment.

ACCOUNTING FOR MEDICARE COSTS AND DEFERRED TAXES UNDER US GAAP:

[1] Net of capitalization and depreciation. See DPU Exhibit 1

The accounting for the tax effects of the post retirement benefit expense and federal subsidy is complex. DPU Exhibit 2 shows a schedule depicting how the deferred tax asset/liability, deferred tax benefit/expense and current income tax benefit/expense are calculated. The schedule shows the calculations in the year the post retirement benefit expense (PRB expense) and subsidy income are accrued as well as the year in which the expense is paid and the subsidy is received. This schedule was prepared through conversations with the Company and responses to data requests. The numbers used in the schedule are only for informational purposes and do not directly correspond to what is being requested by the Company. Here, I will just address some basic concepts relevant to the Company's application.

Over the last five years the accrued PRB expense has given rise to a deferred tax asset (DTA). The DTA is based on the gross PRB accrual. This DTA is reduced (tax benefits realized) in the year the Company pays the accrual. The reduction (realization) of the DTA is based on the gross amount paid and not the amount net of the subsidy. With the change in tax law, the reduction (realization) of the DTA will be based on the net amount. In the meantime, there is a DTA already booked that will not be realized after 2012. GAAP requires that the entire DTA write-off be recorded now. The corresponding GAAP journal entry for the Company is[2].

Deferred Income Tax Expense	$12.4 million	
Deferred Tax Asset		$12.4 million

On a more detailed level, the DTA built up over time is actually offset by a deferred tax liability (DTL). When the Company accrues a PRB cost, the cost is split between expense and capital. The expense gives rise to the DTA discussed previously. The capitalized PRB cost gives rise to a DTL. As such, not only was the DTA written off, but the DTL was written off as a result of the Act. The write off of the DTL has the opposite effect of the DTA write-off. The corresponding journal entry for the Company was[3]:

Deferred Tax Liability	$ 2.8 million	
Deferred Income Tax Benefit		$ 2.8 million

The combination of the two journal entries results in a net deferred income tax expense of $9.7[4] million. When grossed up for taxes, the revenue requirement is approximately $15.6 million. The $15.6 million is the total Company regulatory asset the Company seeks to set up.

ANALYSIS

DPU 2.1 requested information as to how the $2.8 million DTL was calculated. The Company's response yielded the following information which is strictly GAAP based and not what has flowed through to Utah rate payers:

---

[2] See DPU Exhibit 1, Line 23
[3] See DPU Exhibit 1, Line 27 or DPU Exhibit Line 9
[4] See DPU Exhibit 1, Line 10

TABLE 1

Taxable Year Ended	Cost Accrued Before Capitalization	Capitalization Net of Depreciation
March 31, 2005	(5,695,000)	0
March 31, 2006	(9,267,000)	0
December 31, 2006	(8,832,000)	0
December 31, 2007	(11,206,000)	2,916,281
December 31, 2008	(9,348,000)	2,603,172
December 31, 2009	(6,063,000)	1,798,269
Total	**(50,411,000)**	**7,317,722**
Tax Rate		37.951%
Tax Basis for Depreciable Assets		**(2,777,149)**

As can be seen from the information above, for tax purposes, the Company only capitalized the cost associated with the last three time periods. The Company does capitalize labor costs and so a corresponding amount should have been booked for the first three periods. In addition, the information above is only carried through to December 31, 2009. As stated earlier, the Company's revised position in this docket took into consideration information through March 31, 2010. Therefore, Table 1 should include capitalized costs for the first three months of 2010. Assuming a 30% capitalization rate and a 2% depreciation rate per year, the Division revises Table 1 as follows:

TABLE 2

Taxable Year Ended	Cost Accrued Before Capitalization	Capitalization Net of Depreciation
March 31, 2005	(5,695,000)	1,537,556
March 31, 2006	(9,267,000)	2,557,540
December 31, 2006	(8,832,000)	2,477,412
December 31, 2007	(11,206,000)	2,916,281
December 31, 2008	(9,348,000)	2,603,172
December 31, 2009	(6,063,000)	1,798,269
March 31, 2010 (3 Mo)	(2,031,000)	606,254
Total	**(52,442,000)**	**14,496,484**
Tax Rate		37.951%
Tax Basis for Depreciable Assets		**(5,501,561)**

The more detailed calculations incorporating the capitalization and depreciation assumptions can be found in DPU Exhibit 3. By including capitalization for the four time periods, the DTL write-off is increased by $2,724,412 ($5,501,561 in Table 2 - $2,777,149 in Table 1).

It is the Division's understanding that from an IRS perspective, the books for those first three periods in Table 1 are closed and therefore the Company cannot go back and change the numbers from the first three time periods. From a general perspective, the books may be closed and therefore correct for IRS purposes, but the Division does not have evidence to show that the specific uncapitalized treatment of the first three time periods was specifically approved by the IRS. The Division believes that had the IRS or Company been aware of the specific uncapitalized treatment, corrections would have been made to incorporate capitalized treatment. Even though the books are closed for IRS purposes the Division believes that the specific uncapitalized treatment is only implicitly accepted by the IRS. In short, the Division does not believe that an accounting treatment implicitly accepted by the IRS, but incorrect from a principal standpoint should be born by rate payers.

The Division does not believe that this proposed adjustment constitutes retroactive rate making. The numbers used by the Company to calculate the DTA and DTL write-off are strictly GAAP based and are not reflective of what has been used in the development of previous rate cases. In addition to the adjustments mentioned, the Division has also incorporated the SO factor from the Commission Order in Docket 09-035-23. A different SO factor was used in the Company's original application. These calculations can be seen in DPU Exhibit 3.

CONCLUSION

As stated previously, the Division recommends that the Company be allowed to receive deferred accounting treatment and set up a regulatory asset in the amount of $4,667,606[5]. This amount is a $1,830,579[6] reduction to the amount proposed by the Company. This amount includes the capitalization adjustment to the first three periods in Table 1 and the capitalization adjustment for the first three months of 2010. The Division believes that to properly reflect the write-off of the DTL, the calculations should include capitalization of previously accrued post retirement benefit expenses.

[5] See DPU Exhibit 3, line 45
[6] See DPU Exhibit 3, line 47