

## Memorandum

To: The Office of Consumer Services

From: Donna Ramas  
Larkin & Associates, PLLC

Date: July 28, 2010

Subject: Docket No 10-035-38: Comments on Rocky Mountain Power's Application for an Accounting Order Regarding Post-Retirement Prescription Drug Coverage Tax Benefits

### 1 Background

On April 1, 2010, Rocky Mountain Power ("RMP" or "Company") filed an Application with the Public Service Commission of Utah ("Commission") requesting a Deferred Accounting Order for certain tax benefits that will no longer be realized by RMP for certain costs incurred for post-retirement prescription drug coverage as a result of the Patient Protection and Affordable Care Act ("2010 Act"), which was signed into law in March 2010.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 ("2003 Act"), which was signed into law on December 8, 2003, provided a federal subsidy for employers offering post-retirement prescription drug coverage to its retirees that was at least as valuable as the Medicare Part D standard drug benefit. As part of

the 2003 Act, employers were also allowed a tax deduction for the amount that was subsidized and the subsidization was not taxed as income. In other words, even though the portion of post-retirement prescription drug costs would be subsidized or effectively paid for by the federal government, entities were still allowed to deduct the full cost, including the subsidized portion, for federal income tax purposes. The amount of subsidization funds received by RMP was not taxed. For the Company, the impact of the subsidy was first accrued and reflected in the post-retirement benefits expense it recorded on its books during the fiscal year ended March 31, 2005.

The 2010 Act removes this tax deduction associated with the portion of the post-retirement prescription drug coverage that is offset by the subsidy beginning for tax years after December 31, 2012. Qualifying entities, such as RMP, will still receive the subsidy from the federal government and the amount of subsidy received will remain as non-taxable; however, they will no longer be permitted to deduct the amount of expense for which it is subsidized by the government for income tax purposes. For RMP, the additional tax deduction associated with the portion of the prescription drug benefits that are subsidized will no longer be allowed beginning January 1, 2013.

Because the other post employment benefit obligation associated with the prescription drug coverage has historically been deductible for the entire amount paid, including the amount that was projected to be subsidized, a deferred tax asset was recorded associated with the future tax deduction for the full obligation. There was not an offsetting deferred tax liability recorded associated with the subsidized amount as the subsidy received is not taxable. With the 2010 Act, the level of expenditures equal to the subsidy will no longer be deductible; therefore, the deferred tax asset recorded on

RMP's books associated with the expected future tax deduction that RMP will no longer receive must be written-off by RMP on its books. Under Generally Accepted Accounting Principles (GAAP), the Company was required to write-off the deferred tax asset that it will no longer receive in the first quarter of this year.

## 2 RMP's Request, as Revised

In its Application, RMP requested authority to establish a regulatory asset of approximately \$11.4 million on a total Company basis, grossed up to \$18.5 million for tax impacts. The amount on a Utah basis was approximately \$4.7 million prior to the tax gross-up. In response to OCS Data Request 1.5, RMP updated its calculations, requesting a Utah allocated regulatory asset of \$6,498,185. RMP requests that this proposed regulatory asset be amortized over a four-year period, beginning January 1, 2011.

This deferred tax asset that RMP was required to write-off on its books was accumulated by RMP over numerous prior years. The table presented below was prepared using the information provided by RMP in response to data requests OCS 1.5, OCS 1.7, and DPU 2.1. This table ties into the \$6,498,185 regulatory asset requested by RMP and breaks down the accumulation of the outstanding subsidy receivable that will no longer be tax deductible beginning in 2013 into the respective historic periods over which it was accumulated.

<u>Fiscal Year Ending:</u>	<u>Retiree Drug Subsidy Accrued</u>	<u>Retiree Drug Subs. Received</u>	<u>Remaining Subsidy</u>
March 31, 2005	\$ 5,695		\$ 5,695
March 31, 2006	\$ 9,267		\$ 9,267
PPM Spinoff	\$ (225)		\$ (225)
December 31, 2006	\$ 9,057	\$ 1,842	\$ 7,215
December 31, 2007	\$ 11,206	\$ 1,708	\$ 9,498
December 31, 2008	\$ 9,348	\$ 3,863	\$ 5,485
December 31, 2009	\$ 6,063	\$ 2,680	\$ 3,383
Thru March 31, 2010	\$ 2,031	\$ 775	\$ 1,256
NPV of Remaining Subsidy Thru 2012		\$ 8,787	\$ (8,787)
Cumulative Subsidy That Will Not be Deductible			\$ 32,787
Tax Rate			37.951%
Future Lost Tax Benefits of Non-Deductible Post Retirement Benefits			\$ 12,443
Less: Portion Capitalized By Company - 2007 through 2009 only			\$ (2,777)
Lost Future Tax Benefits Requested by Company			\$ 9,666
Revised Protocol Allocation Factor:SO			41.7145%
Utah Allocated Portion			\$ 4,032
Tax Gross-up Factor			1.6116
Requested Regulatory Asset - Utah Basis			\$ 6,498

The above amounts are in thousands of dollars and are derived from information provided by RMP. The resulting amount equals the regulatory asset requested by RMP.

As shown in the calculations presented above, RMP's proposed regulatory asset incorporates the retiree drug subsidy that was accrued beginning as far back as the fiscal year ended March 31, 2005, or essentially beginning April 1, 2004.

In the opening paragraph of its Application, RMP states that it is requesting an accounting order "...authorizing the Company 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 a result of the Patient Protection and Affordable Care Act..." (emphasis added) Again in paragraph 4 of its Application, RMP states: "The purpose of this Application is to request authorization for

the recording of a regulatory asset for tax benefits previously reflected in rates that will no longer be realized as the result of the Act.” (emphasis added) In paragraph 8, RMP states that “...the actuarially determined level of OPEB expense is included in the Company’s annual expenses in its revenue requirement/cost of service, and the Company has treated the OPEB expense as deductible for income tax purposes, including the portion that is offset by the federal subsidy.”

While it is correct that RMP has reflected the additional tax benefit associated with the tax deductibility of the portion that is offset by the federal subsidy in several recent cases, it did not do so historically. In fact, the amount of regulatory asset requested by RMP greatly exceeds the amount of benefits that have been passed on to RMP’s customers in the past. While RMP contends that the regulatory asset is associated with tax benefits previously reflected in rates, it has not calculated the amount of its requested regulatory asset based on amounts that had, in fact, been included in rates.

### 3 RMP Failed to Reflect the Tax Benefit in Several Prior Utah Rate Cases

As previously mentioned, the federal subsidization of a portion of retiree prescription drug benefits was implemented as a result of the 2003 Act, which was signed into law December 8, 2003, with the prescription drug subsidy first being accrued and reflected in the post-retirement benefits expense calculations for RMP during its fiscal year ended March 31, 2005. This fiscal year would have begun April 1, 2004 and would have been the first fiscal year beginning for RMP after implementation of the 2003 Act. Since the implementation of the 2003 Act, RMP’s base rates charged to Utah

customers have changed five times as a result of five general rate cases during the period 2005 to date. Based on information provided by RMP in response to several OCS data requests in this case, the tax benefits associated with the deductibility of the amount of retiree prescription drug benefits that are subsidized by the federal government were only passed on to customers as part of the revenue requirement calculations in three of those five cases. In the first two cases for which rates were implemented subsequent to the enactment of the 2003 Act, RMP did not include the additional tax benefit in the income tax calculations incorporated in its case.

The table below lists each of the Utah general rate cases that have been decided since the implementation of the 2003 Act by docket number and identifies the date of the Commission's Order, the rate effective date, and the test period used by RMP in that case. Also presented is an indication of whether or not the additional tax benefit was reflected in the tax calculations presented by RMP in that case.

<u>Docket No.</u>	<u>Future Test Period End Date in Filing</u>	<u>Rate Effective Date</u>	<u>Date Order Issued</u>	<u>Add'l Tax Benefit from Deductibility of Federal Subsidy Reflected?</u>
04-035-42*	March 31, 2006	March 1, 2005	February 25, 2005	No
06-035-21*	September 30, 2007	December 11, 2006	December 1, 2006	No
07-035-93	December 31, 2008	August 13, 2008	August 11, 2008	Yes. No capitalization offset.
08-035-38*	December 31, 2009	May 8, 2009	April 21, 2009	Yes
09-035-23	June 30, 2010	February 18, 2010	February 18, 2010	Yes

\* indicates settlement

In a presentation by RMP at the June 1, 2010 Technical Conference in this case,

RMP walked the parties step by step through information from its recent general rate case, Docket No. 09-035-23. The information was provided as hand-outs to the parties that participated in the Technical Conference. As part of the presentation, RMP was able to demonstrate that it had, in fact, reflected the projected impact of the deductibility of the portion of the prescription drug benefit that is subsidized by the federal government (or “Medicare subsidy”) as part of the income tax calculations in its most recent rate case. The “Medicare Subsidy” was projected as \$7,000,000 on a total Company basis or \$2.89 million on a Utah basis in the test period in Docket No. 09-035-23. This Medicare Subsidy amount was reflected as a Schedule M Deduction in RMP’s income tax calculations in the case. The deduction was reflected as a “permanent deduction” Schedule M item in RMP’s general rate case and was used to reduce the taxable income to which the income tax rate used in the case was applied. Thus, the income tax expense did reflect the benefit of the deductibility of the amount of subsidy that RMP projected it would accrue in the test year in that case, which was the twelve months ending June 30, 2010. That projected tax benefit is incorporated in current rates.

In response to OCS Data Requests 2.3 and 2.4, as well as Attachment OCS 2.1c-1 provided in response to OCS Data Request 2.1, RMP was able to demonstrate that it also reflected the income tax benefits associated with the deductibility of the Medicare subsidy in calculating its revenue requirement in Docket Nos. 07-035-93 and 08-035-38. The additional benefits were reflected as permanent Schedule M Deductions in the tax workpapers provided by the Company in response to discovery in this case and tied into the income tax calculations in the Company’s filings.

However, based on the responses and information provided by RMP in this case (specifically the responses to OCS 2.1 and OCS 2.2) it appears that the additional tax benefits associated with the deductibility of the Medicare subsidy were not reflected in the Company's filings in Docket Nos. 04-035-42 and 06-035-21. OCS Data Requests 2.1 and 2.2 specifically asked the Company to identify the amount of Medicare subsidy that was flowed through the income tax calculations in each of these dockets, and to identify the amount on a total Company and on a Utah jurisdictional basis. The Company indicated that for each of these cases, no book-tax differences were specifically identified for the Medicare subsidy. Based on the Company's responses and its inability to identify any tax benefits associated with the Medicare subsidy being factored into the revenue requirement calculations in Docket Nos. 04-035-42 and 06-035-21, it is apparent that these tax benefits were not passed on to ratepayers until rates resulting from Docket No. 07-035-93 went into effect on August 13, 2008. This is over four-years after the initial fiscal year in which RMP would have accounted for the federal subsidy and over four-years after the date at which RMP bases its calculation of its requested regulatory asset in this case.

4 If a Regulatory Asset Is Authorized, it Should be Limited to the Amount by which Ratepayers have Historically Benefited

While RMP contends that it is requesting authorization to "...record a regulatory asset associated with tax benefits previously reflected in rates that will no longer be realized...", the amount it is requesting to establish as a regulatory asset goes well beyond the level of tax benefits that have previously been reflected in rates charged to



RMP's Utah customers. Again, as stated above, RMP did not begin to reflect the tax benefits in rates until August 13, 2008. The Utah customers of RMP received no tax benefit associated with the deductibility of the Medicare subsidy resulting from the 2003 Act until over 4 ½ years subsequent to the date the 2003 Act was signed into law. Despite this fact, RMP's calculation of the amount for which it is seeking regulatory asset recovery of in this case begins with amounts dating back to the fiscal year that began on April 1, 2004. This is four years and three months prior to the date that any of the tax benefits began to flow to Utah customers.

The establishment of a regulatory asset would mean that the Commission is allowing special treatment for this item beyond what would otherwise occur. The authorization and establishment of a regulatory asset should not be taken lightly. For book purposes, under GAAP, RMP was required to write-off the deferred tax asset recorded on its books that is associated with future projected tax benefits that it will no longer receive as a result of the 2010 Act. In evaluating this issue, the Commission should be cognizant of the fact that there was no cash impact to RMP on the date it was required to write-off the deferred tax asset on its books and records. The deferred tax asset was associated with projected future tax deductions and the amount of write-off is associated with the loss of future tax deductions after January 1, 2013.

If the Commission opts to allow a regulatory asset in this case, the amount of regulatory asset should be greatly reduced from the amount requested by RMP. The amount of regulatory asset established, if one is established, should not exceed the benefit that Utah ratepayers received. The Company should not be allowed special treatment through the establishment of a regulatory asset and recovery from customers

for non-cash amounts associated with lost projected benefits that were never passed on to customers to begin with. It would be unfair to customers to grant special treatment as a regulatory asset for this item at a level that exceeds the benefits that the customers have received. The calculation of the appropriate level of regulatory asset can be done multiple ways, as I explain below. Under RMP's proposal, it would have the Commission establish a regulatory asset as though customers had historically received the full benefit in rates associated with the projected future deductibility of the Medicare subsidy that is now lost, even though such benefits did not begin to flow to customers until August 2008.

5 There are Many Options Available to the Commission in Determining the Appropriate Level of Regulatory Asset

If the Commission chooses to allow the establishment of a regulatory asset in this case, then there are many options available to the Commission in establishing the appropriate level of the regulatory asset. It would be unfair to allow the establishment and subsequent amortization of the regulatory asset for an amount that exceeds the amount by which Utah ratepayers have benefitted historically as a result of the projected tax deductibility of the Medicare subsidy that will now be lost. I present two methods of calculation below, one of which results in a total allowed regulatory asset of \$3,826,431 and the other \$1,754,510 (in comparison to the Company's request for a regulatory asset of \$6,498,185).

One option for determining the allowed level of regulatory asset would be to determine the amount by which Utah customers have benefitted historically as a result

of RMP's inclusion of the tax deduction associated with the Medicare subsidy that will now be lost in past general rate cases, and to add to that the benefit included in current rates that will be lost in the future through the projected date of the implementation of rates in RMP's next general rate case. Under this option, the amount of regulatory asset would be limited to the amount of projected future tax benefits that will be lost as a result of the 2010 Act that have historically been and continue to be passed on to customers in rates. However, in deriving this amount, many assumptions would need to be made.

Exhibit 1, attached to this Memo, estimates the amount of tax benefits associated with the deductibility of the Medicare subsidy that have flowed to Utah ratepayers in the past and will continue to flow to ratepayers until the implementation of rates that will result from the next RMP general rate case in Utah. In estimating this amount, it was necessary to make several assumptions, one of which is the date that rates from the next RMP general rate case in Utah will go into effect. The exhibit assumes that those rates, which presumably will not reflect the impact of the tax benefits that will be lost for tax purposes beginning January 1, 2013, will be implemented effective September 1, 2011. Thus, the calculation presented in Exhibit 1 acknowledges the fact that the reduction in income tax expense associated with the projected future deductibility of the Medicare subsidy is included in current rates being charged to customers. The amounts presented in this exhibit for the past cases in which RMP incorporated the tax benefit in its revenue requirement calculations, Docket Nos. 07-035-93, 08-035-38 and 09-035-23, were taken directly from information provided by RMP in this case in response to discovery requests and in the hand-outs provided in the Technical

Conference.

In response to discovery in this case, RMP has also provided the projected amount of Medicare subsidy cash receipts that it will receive during the period 2010 through 2012 that will still be deductible in those tax years. Based on that information, approximately 24% of the outstanding Medicare subsidy receivable that was factored into RMP's calculations is anticipated to remain tax deductible through 2012. Thus, on Exhibit 1, at line 11, the total amount of benefits estimated flowing to Utah ratepayers through August 31, 2011 was reduced by 24% to reflect the future remaining deductibility of a portion of those amounts. Under this option, incorporating various assumptions, the resulting regulatory asset would be no more than \$3,826,431 on a Utah basis, which is \$2,671,754 less than the \$6,498,185 amount requested by RMP.

The Commission may wish to select a more simplified approach in deriving the allowed amount of regulatory asset. The write-off of the deferred tax assets was required to occur on or about March 31, 2010. RMP's calculation of the requested deferred regulatory asset was calculated based on the remaining amount of subsidy that will be lost that was accrued as a deferred tax asset over the period April 1, 2004 through March 31, 2010, a period of 72 months. Ratepayers began to receive the tax benefits resulting from the Medicare subsidy in rates beginning August 13, 2008, which equates to a period of approximately 19.5 months from the date ratepayers began to receive the tax benefit resulting from the 2003 Act to the date the deferred tax asset was required to be written off on RMP's books as a result of the 2010 Act. The Commission could apply the resulting ratio of months ratepayers benefited during the period the deferred tax asset was accrued to the period used by RMP in deriving its

proposed regulatory asset, which would result in an allowance factor of 27%. The calculation of this proposed allowance factor, as well as the resulting amount of allowable regulatory asset, is presented below:

Number of Months from Inception Through Write-off (April 1, 2004 through March 31, 2010)	72
Number of Months Benefit Reflected in Rates Through Write-off (August 13, 2008 through March 31, 2010)	19.5
Allowance Factor (19.5 months / 72 months)	<u>27%</u>
Regulatory Asset Requested by RMP - Utah Basis	<u>\$ 6,498,185</u>
Allowable Regulatory Asset	<u>\$ 1,754,510</u>
Reduction to RMP's requested Regulatory Asset	<u>\$ (4,743,675)</u>

If the Commission allows a regulatory asset to be established, I recommend that the amount be limited to the \$1,754,510 calculated above. This option would represent a more simplified approach in deriving the allowed amount of regulatory asset and would incorporate fewer assumptions than would need to be made in taking a more precise approach.

Another option available to the Commission is to reject RMP's request outright. There are ample grounds to do so, including the fact that the Company did not pass the tax benefit associated with the Medicare subsidy to ratepayers for two full rate cases after the benefit began to be realized by RMP as a result of the 2003 Act. The past behavior and failure to pass this benefit to customers should not now be rewarded through the allowance of the full level of regulatory asset requested by RMP. As previously indicated, there was no cash outlay made by RMP as a result of the write-off of the deferred tax asset in March 2010. This was an entry made by RMP on its books with no cash impact. The write-off is associated with the projected loss of future tax benefits beginning in January 2013.

6 There are Problems with the Way RMP has Reflected the Impact of the Medicare Subsidy in Prior General Rate Cases

There are problems with RMP's treatment of the tax deductibility of the Medicare subsidy in past general rate case proceedings. The most significant problem is the fact that RMP did not pass this tax benefit to customers in rates until August 13, 2008, which is over four years after the 2003 Act was implemented and subsequent to two separate rate case proceedings following the implementation of the 2003 Act.

Additionally, RMP has not been consistent in capitalizing its post retirement benefits. According to RMP's response to DPU Data Request 2.1, RMP did not begin making the permanent book-tax difference to adjust book to tax basis for income tax purposes until the taxable year ended December 31, 2007. The capitalized portion of the non-deductible post-retirement benefits, totaling \$2,777,149, was reflected as a reduction in RMP's calculation of its proposed regulatory asset. Had the Company consistently capitalized a portion of the post-retirement benefit costs instead of beginning such capitalization in 2007, the amount of offset for capitalization would have been greater, thereby resulting in a lower amount of proposed regulatory asset.