ROCKY MOUNTAIN POWER
A DIVISION OF PACIFICORP

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August 19, 2010

***VIA ELECTRONIC AND HAND DELIVERY***

Utah Public Service Commission
Heber M. Wells Building, 4th Floor
160 East 300 South
Salt Lake City, UT 84114

Attention: Julie P. Orchard
Commission Secretary

RE: Docket No. 10-035-38
Response Comments of Rocky Mountain Power; In the Matter of the Application of Rocky Mountain Power for an Accounting Order Regarding Post-Retirement Prescription Drug Coverage Tax Benefits

On April 1, 2010, Rocky Mountain Power (the "Company") filed an accounting application with the Public Service Commission of Utah (the "Commission"), requesting that the Commission authorize the Company to record a regulatory asset related to a change in tax treatment of post-employment prescription drug coverage resulting from the enactment of the Patient Protection and Affordable Care Act (the "Act") on March 23, 2010.[1] On a Utah basis, the Company sought a regulatory asset of approximately $6.437 million.

After two months of discovery, the Company, the Division of Public Utilities (the "Division") and the Office of Consumer Services (the "Office") met on July 7, 2010, for a settlement conference. While no comprehensive settlement was reached, the conference led to the development of an alternative proposal that both the Division and the Company submit is reasonable and in the public interest.[2] In the alternative proposal attached as Exhibit RMP-1, the Company would record a regulatory asset of $6.284 million (Utah), reflecting an adjustment for capitalization with respect to the three-months ended March 31, 2010. While this alternative proposal provides a lower recovery than the Company's application supports, the Company is willing to accept the proposal as a reasonable compromise.

These comments support the alternative proposal and respond to the comments of the Office filed on July 28, 2010. A hearing before the Commission is scheduled for September 1, 2010.

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[1] The Act was subsequently modified by the Health Care and Education Reconciliation Act, which was signed into law on March 30, 2010.

[2] The alternative proposal has also been discussed with the Office. As of the date of these Comments, the Office has not provided its support for the alternative proposal.

## BACKGROUND

For income tax purposes, post-retirement benefits are deductible when paid. Prior to the enactment of the Act on March 23, 2010, the Company had recorded a deferred income tax asset on its books, representing a future tax benefit for all of the Company's accrued, but unpaid, other post-employment benefit (OPEB) obligation, including the portion of that obligation that is allocable to a federal subsidy for post-retirement prescription drug benefits.[3]

The Act modifies the Internal Revenue Code and for tax years beginning after December 31, 2012, the portion of post-retirement prescription drug benefit costs subsidized by the federal government will no longer be deductible for income tax purposes. The amount of non-deductible post-retirement prescription drug benefits will be equal to the amount of the federal drug subsidy received in the same taxable year.

In accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 740, *Income Taxes*, (formerly known as FASB Statement No. 109, *Accounting for Income Taxes*), the Company was required to adjust this deferred income tax asset associated with post-retirement benefits to reflect this change when the Act became law. The adjustment reducing the Company's deferred income tax asset by $9,665,845 was made as of March 31, 2010.

Without deferred accounting, the Company will incur a one-time charge for additional deferred income tax expense and will not have the opportunity to recover the additional income tax expense generated by this adjustment in future rate proceedings.

## REPONSE COMMENTS

### *The Costs Incurred by the Company as the Result of the Act Meet the Commission's Requirements for Deferred Accounting*

The Company timely filed its application for deferred accounting on April 1, 2010, just two days after passage of the Act, for an expense incurred as a direct result of the Act's changes to the tax deductibility of post-retirement prescription drug benefit costs. This is precisely the kind of unforeseen and extraordinary change in expense for which the Commission has previously allowed an accounting order. *See In re Rocky Mountain Power*, Report and Order at 17, Docket Nos. 06-035-163; 07-035-04; 07-035-14 (Jan. 3, 2008). The Act's change in tax law is an event outside of the Company's control and that could not have been foreseen at any time during the Company's prior general rate case(s). The event is extraordinary both because of the amount of the expense incurred and because the event is infrequent. In addition, the adjustment to the

[3] Designed to encourage employers to continue providing high quality prescription drug coverage, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 contains provisions for a federal subsidy for employers offering post-retirement prescription drug coverage to its retirees that is at least as valuable as the Medicare Part D standard drug benefit.

Company's deferred income tax asset is based on the occurrence of current and future events, not a review of the past accounting which properly reflected the tax law in effect at the time.
In its comments, the Division finds that this event meets its guidelines for deferred accounting and recommends that the Commission grant deferral. The Office's comments make no arguments against this event meeting the requirements for deferred accounting.

***The Office's Analysis is Based on a Related, but Different Tax Attribute***

While the Company's application is admittedly complex, the proper analysis of it requires an accurate distinction between the *expense accrued for post-retirement prescription drug benefits* (the subject of the application) and permanent book-tax differences related to book *income* accrued for the *federal retiree drug subsidy* (the basis of the Office's recommended adjustments). The Office reviewed the treatment of the latter issue in the Company's prior general rate cases dating back to 2004. This issue is not impacted by the Act; since its inception, the federal retiree drug subsidy has been treated as tax-exempt income by the Internal Revenue Code and in no way was this modified by the Act. This issue is not addressed in the Company's application; this application deals with the adjustment to the Company's deferred income tax asset required because a portion of the book expense accrued for post-retirement prescription drug benefits will no longer be deductible for income tax purposes.

Prior to the Act, the portion of post-retirement prescription drug benefits allocable to the federal retiree drug subsidy was exempted from the general rule of the Internal Revenue Code that provides no tax deduction for expenses incurred for the generation of tax-exempt income. This exemption was struck by the Act, and for years beginning after December 31, 2012, the portion of post-retirement prescription drug benefits allocable to the federal retiree drug subsidy falls under the general rule and is no longer tax deductible. For taxable years beginning after December 31, 2012, the amount of non-deductible post-retirement prescription drug benefits reported on the Company's income tax returns will be equal to the amount of the federal drug subsidy received in cash during the same taxable year. In this manner, the two tax attributes are related.

Accordingly, the adjustment to the Company's deferred income tax asset for non-deductible post-retirement prescription drug benefits was quantified as the amount of federal retiree drug subsidy accrued as of March 31, 2010, but not expected to be received until after December 31, 2012.

The tax-exempt income generated by the federal retiree drug subsidy and the non-deductible post-retirement prescription drug benefits are distinctly separate tax attributes governed by separate sections of the Internal Revenue Code. Under its analysis, the Office is essentially arguing that since the rate effective date of the Company's 2004 general rate case (Docket No. 04-035-42) the Company has under-provided an income tax benefit related to tax attribute A and therefore should not be able to establish a regulatory asset for the income tax expense incurred as the result of the Act for tax attribute B. In addition to improperly conflating two different tax issues, the Office's position raises numerous legal and policy issues associated with the attempt to true-up the requested regulatory asset to an amount estimated to be reflected in rates over a period that spans more than five years and is covered by five separate rate cases, three of which were settled in "black box" compromises.

***Post-Retirement Benefits Have Been Reflected as Tax Deductible***

The tax benefits of the Company's post-retirement benefits have been reflected in each of the five general rate cases analyzed by the Office for its memorandum. This is evidenced by the inclusion of post-retirement benefits expense in the regulatory pre-tax book income with no related permanent book-tax difference reducing the book level of expense to arrive at the regulatory taxable income.

For ratemaking purposes, the Company records its income taxes on a fully normalized basis in Utah. On a fully normalized basis, income tax benefits are recorded in the same accounting period as the related book accrual, even if the tax benefits will not be realized until a future tax period for tax compliance and cash purposes.

***The Adjustment Calculations Presented by the Office are Overly Simplistic and Omit and/or Inadequately Justify the Assumptions Used***

The Office advises in its memorandum that "there are many options available to the Commission in establishing the appropriate level of the regulatory asset." The Office offers three options, the first of which is computed in OCS Exhibit 1. While the Office generally describes the adjustment made on line 11 of this calculation, it does not adequately justify its necessity. The calculation estimates the amount of retiree drug subsidy treated as tax-exempt income in the Company's prior general rate cases; line 11 seems to improperly treat a portion of this tax-exempt income as tax deductible. Furthermore, the Office describes this method as requiring many assumptions, but they disclose only one.

However, because of the complexities of attempting to quantify the amount of tax benefits previously reflected in rates over the past five years, the Office recommends the more simplified approach taken in their second option, computed on page 13. The Office's recommendation is based on a standard of requiring fewer assumptions over a standard of being precise, supported by fact, and based on regulatory principles.

Finally, the Office advises that the Commission may reject the Company's application outright. The Office offers no related calculations or regulatory support other than pointing to what it generally describes as Company missteps in the regulatory process dating back to 2004 with respect to a related, but different tax attribute, and the Office does not analyze the prior rate cases for any other potential tax attributes that would be offsetting in nature. The Office also ignores the fact that the requested regulatory asset will not be included in a balancing account, and the Company will not be guaranteed full recovery of the deferral. Because the Company is agreeing to start the amortization of the regulatory asset on January 1, 2011, over eight months prior to the amortization being included in rates, the Company will likely not receive full recovery of the regulatory asset.

***The Division and the Company Have Reached a Fair Compromise***

The Commission should reject the Office's proposed adjustments and approve the alternative proposal supported by the Company and the Division. The Company continued discussions with the Division subsequent to the filing of the Division's comments on July 28, 2010, to address its recommended adjustment to the Company's requested regulatory asset. Imputing capitalization for the tax years ended March 31, 2005, March 31, 2006, and December 31, 2006 as proposed by the Division would amount to a double counting of the tax benefits, because by not capitalizing the tax benefits in those years a greater tax benefit was realized than would have been without the capitalization. In the alternative proposal attached as Exhibit RMP-1, the Company accepts the adjustment for capitalization with respect to the three-months ended March 31, 2010. The terms of the alternative proposal reflect a reasonable compromise of the issues raised in the Division's comments and the Company's application.

Sincerely,

Jeffrey K. Larsen
Vice President, Regulation

cc: Division of Public Utilities
Office of Consumer Services