BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

DOCKET NO. UM ____

IN THE MATTER OF THE APPLICATION OF AVISTA CORPORATION FOR AN ORDER FOR APPROVAL TO CHANGE ITS ACCOUNTING FOR FEDERAL INCOME TAX EXPENSE FOR CERTAIN PLANT BASIS ADJUSTMENTS AND DEFERRAL OF ASSOCIATED CHANGE IN TAX EXPENSE	) APPLICATION) FOR AUTHORIZATION) OF DEFERRAL OF) INCOME TAX EXPENSE

Avista Corporation, dba Avista Utilities ("Avista" or "Company"), pursuant to ORS 757.259 and OAR 860-027-0300, applies to the Public Utility Commission of Oregon ("Commission") for an order authorizing Avista to change its accounting for federal income tax expense from a normalization method to a flow-through method for certain plant basis adjustments, including Industry Director Directive No. 5 (IDD #5) and meters. As described more fully below, Avista is currently calculating federal income taxes utilizing the normalization method for the majority of plant-related temporary book-to-tax differences. This proposal would allow Avista to utilize the flow-through method on certain plant basis adjustments, which will provide immediate benefits to customers. With this application, the Company is proposing to defer those benefits and to begin to provide those benefits to customers in its next filed general rate case.

In support of this Application, the Company states:

Avista provides natural gas service in southwestern and northeastern Oregon and is a public utility subject to the Commission's jurisdiction under ORS 757.005(1)(a)(A).

Avista requests that all notices, pleadings and correspondence regarding this Application be sent to the following:

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This Application is filed pursuant to ORS 757.259, which empowers the Commission to authorize the deferral of expenses or revenues of a public utility for later incorporation into rates. As required by ORS 757.259(4), any amortization of the Deferred Amount will be subject to an earnings review and a finding by the Commission that the costs were prudently incurred. Avista does not expect that amortization of the Deferred Amount will cause Avista to meet or exceed its most recently authorized return on equity.

I. BACKGROUND

During 2020, Avista worked with consultants (Deloitte and Ernst and Young) on a tax review project[1]. The outcome of this project was to expand on the tax deduction for repairs expenses that the Company originally implemented in 2014 and to modify its tax method for accounting for certain costs relating to meters and mixed service costs (IDD #5). This change allowed the Company to deduct costs for tax purposes that previously were capitalized, thereby reducing current federal income taxes owed to the Internal Revenue Service (IRS). This change was included with the 2019 federal tax return that was filed in October 2020. While the Company expanded its deduction for repairs expenses, the deferred taxes for this deduction will continue to

[1] With the enactment of the Tax Cuts and Jobs Act (TCJA) passed in December 2017, the Company was no longer able to utilize bonus depreciation under IRC Section 168(k). The Company entered into the 2019 tax review project as a replacement for tax cash savings.

be normalized and therefore, are not part of this tax method of accounting change and deferral application. Since the meters and IDD #5 basis adjustments were new, Avista determined that the flow-through method of tax accounting would be appropriate, as described below, which allows the tax benefits to be given to customers over a shorter period than if using the normalization method.

Attachment A provides two forms that were provided by Deloitte that Avista included in its 2019 Federal Income Tax Return that was filed in October 2020 (Form 3115, Application for Change of Accounting Method). These forms describe the new basis adjustments (IDD #5 and meters) that were included with this deferral application.

II. <u>CALCULATION OF FEDERAL INCOME TAXES</u>

Federal income taxes are computed by Avista in general rate cases as follows:

- First, current federal income tax is calculated. The starting point is "income before tax adjustments" (or pre-tax operating income). Deductible interest expense computed using rate case concepts (interest synchronization) is subtracted from pre-tax operating income to arrive at "net operating income before taxes". Federal income tax temporary and permanent adjustments, known as "book-to-tax" or "M-1" adjustments, are added or subtracted from net operating income before taxes to produce what is commonly known as the federal tax base. The federal tax base is reduced by the current state income tax deduction to arrive at federal taxable income. Federal taxable income is multiplied by the statutory corporate federal tax rate of 21% to arrive at the current federal income tax liability.
- Second, the provision for deferred income taxes is computed by multiplying the normalized temporary book-to-tax differences from the current income tax calculation by the applicable statutory income tax rate. The resulting deferred income tax expense is also the net annual change to the accumulated deferred federal income taxes (ADFIT) component of rate base.
- Third, the amortization of the excess deferred federal income tax (EDIT) that arose in the Tax Cuts and Jobs Act of 2017 is computed using the average rate assumption method (ARAM) and is recorded as a reduction to federal income tax expense.

Normalization versus Flow-Through

There are two methods that regulated utilities may use to record the federal income taxes related to book-to-tax differences, normalization and flow-through. Using a normalization method to compute income tax expense simply means that all of the income tax costs related to items in the current period will be computed, whether paid in the current year or paid later. This method creates deferred income tax and the associated accumulated deferred income tax that is subtracted from rate base.[2] Flow-through accounting generally treats the actual current Federal income tax liability of the regulated utility as the utility's tax expense in determining utility rates. Thus, under flow-through accounting, the tax benefits of accelerated tax expense and other similar items are taken into account immediately in determining utility rates (through their effect of reducing current income tax expense). Accumulated deferred tax reserves related to tax items that have been flowed through are not included in the rate base calculation as the tax benefit was provided to customers.

A normalized book-to-tax difference is a temporary difference that for accounting purposes adjusts current income tax expense and has an equal offset in deferred income tax expense, thus the net effect to total book income tax expense is zero. A flow-through book-to-tax difference is also a temporary difference that adjusts current income tax expense, but does not have an offsetting deferred income tax expense amount. This is illustrated in the following example using depreciation expense as the timing difference in Tables 1 through 3.

[2] Avista is required to treat certain plant-related items in a manner consistent with the Internal Revenue Code normalization requirements and consistency rule in order to avoid a normalization violation. Specifically, the plant related items should be passed through to customers no more quickly than over the remaining book life of the underlying assets. Additionally, all of the following items must be treated consistently: depreciation expense, tax expense (including deferred tax expense), accumulated deferred taxes on the balance sheet, and rate base.

Table 1: Example – Depreciation Book-to-Tax Difference

Example Depreciation Information

Asset Cost = $400
Book Life = 4 years
Tax Life = 2 Years

	Book Depreciation Expense	Tax Depreciation Expense	Book-to-Tax Difference
Year 1	$ 100	$ 200	$ 100
Year 2	100	200	100
Year 3	100	-	(100)
Year 4	100	-	(100)
Total	$ 400	$ 400	$ -

Table 1 above shows that for tax purposes, the Company will deduct $100 more for tax purposes than for book in the first two years and then that will reverse over the next two years. Therefore, at the end of the four years, the Company will have recorded a book and tax deduction for the entire $400 investment. This provides a cash benefit to the Company from the IRS.

Table 2: Example - Normalization Method

Federal Income Tax Expense using Normalization

	Current Tax Expense (Benefit)	Deferred Tax Expense (Benefit)	Total Tax Expense (Benefit)
Year 1	$ (42)	$ 21	$ (21)
Year 2	(42)	21	(21)
Year 3	-	(21)	(21)
Year 4	-	(21)	(21)
Total	$ (84)	$ -	$ (84)

Using the normalization method of accounting for book-to-tax differences, the Company would record a consistent $21 tax benefit in each of the four years. This is done by recording deferred taxes on the book-to-tax differences. Customers do not realize the benefit of the timing difference (lower tax expense) in the first two years using this method. (However, customers do benefit from a lower rate base as ADFIT is an offset to rate base lowering net plant.)

<u>Table 3</u>: Example – Flow-Through Method

Federal Income Tax Expense using Flow-Through			
	Current Tax Expense (Benefit)	Deferred Tax Expense (Benefit)	Total Tax Expense (Benefit)
Year 1	$ (42)	$ -	$ (42)
Year 2	(42)	-	(42)
Year 3	-	-	-
Year 4	-	-	-
Total	$ (84)	$ -	$ (84)

Using the flow-through method of accounting for the book-to-tax differences, the Company would record the tax benefit in the first two years. This is done by recording no deferred taxes on the book-to-tax differences within the income statement. Using this method, customers realize the tax expense benefit of the timing differences allowed by the IRS in the first two years. However, customers do not benefit from a lower rate base as there is no ADFIT to offset or lower net plant.

III. PROTECTED VS NON-PROTECTED ASSETS

The IRS requires normalization on book-to-tax differences it considers <u>protected</u>. The capitalizing of utility property under IRC§ 263(a) constitutes protected assets that are subject to the normalization requirement under IRC § 168(i)(9). The two primary areas that give rise to protected differences are book-to-tax differences for depreciation method and depreciable life of the asset (commonly referred to as "method/life differences"). The normalization requirements of the Internal Revenue Code are designed to prohibit the direct or indirect flow-through of accelerated depreciation tax benefits to utility customers. Other book-to-tax differences not related to method/life differences are considered non-protected, such as expenditures capitalized for book purposes but allowed as a deduction for tax purposes. These non-protected book-to-tax differences are not required to be normalized.

Avista records the accumulation of deferred taxes on plant book-to-tax differences in FERC Account No. 282900. As of December 31, 2019, FERC Account No. 282900 contained a balance of $819 million that has been normalized prior to adjustments related to the strategic tax review. After adjustment for the strategic tax review, the estimated balance is $885 million. Much of this balance is protected because it relates to accelerated depreciation including bonus depreciation.[3] However, included in FERC Account No. 282900 is non-protected basis adjustments. Avista has historically normalized the entire FERC Account No. 282900 balance. However, Avista is proposing a change to the flow-through method for certain non-protected basis adjustments discussed below.

Table 4 provides a breakdown of the protected and non-protected deferred tax balances, after adjustment for the 2019 tax review, as of December 31, 2019.

Table 4: FERC Account No. 282900 ADFIT Detail

FERC Account No. 282900 - ADFIT Estimated Balance at December 31, 2019	
Protected	$ 599,773,098
Non-Protected - Proposed Flow-Through	106,824,795
Non-Protected - Other	178,574,508
	$ 885,172,401

[3] Bonus depreciation is a tax incentive that allows a business to immediately deduct a large percentage of the purchase price of eligible assets, such as machinery, rather than write them off over the "useful life" of that asset.

There is no restriction from the IRS on changing to flow-through for non-protected assets. Per guidance in a Private Letter Ruling[4], (PLR 202010002), which has been provided as Attachment B, the Internal Revenue Service held that the ADFIT resulting from the repair related IRC § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of the IRC § 168(i)(9). They also held that the ADFIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement and (2) deducted as repairs under IRC §162 to public utility property within the meaning of IRC § 168(i)(10) pursuant to the tax method of accounting change for repairs, is not subject to the normalization method of accounting.

In PLR 202033002, also provided in Attachment B, the IRS ruled that depreciation-related ADFIT balances attributable to costs that were capitalized into depreciable tax basis of public utility property prior to a change in tax method of accounting, reclassifying such costs as current deductions, do not remain subject to the Section 168(i)(9) deferred tax normalization rules, after the changes in tax method of accounting (and, thus, presumptively are not required to be reversed using ARAM).

IV. **REASON FOR PROPOSAL**

By changing to the flow-through method of accounting for certain basis adjustments, including IDD #5 and meters, Avista will have an estimated $106 million (system) of ADFIT as of December 31, 2019, which represents approximately $134 million (system) that can be recorded

[4] Private Letter rulings obtained by other companies are used as guidance in determining how the IRS may rule when facts and circumstances are similar. Avista's facts and circumstances related to the non-protected basis adjustments described in this application are similar to the facts and circumstances included in recent private letter rulings attached as Attachment B, and therefore will not require one specific for Avista.

in a regulatory liability and used to offset customers' rates in future general rate cases. A summary of the estimated ADFIT amount by jurisdiction is shown in Table 5 below.

<u>Table 5</u>: Tax Benefit by Jurisdiction at December 31, 2019

Tax Impact of Basis Adjustments (IDD #5 and Meters) December 31, 2019		
	ADFIT	Grossed-up for Federal Taxes
WA Electric	$ (40,748,313)	$ (51,580,143)
ID Electric	(21,941,399)	(27,773,923)
WA Natural Gas	(19,653,292)	(24,877,585)
ID Natural Gas	(8,422,839)	(10,661,822)
OR Natural Gas	(15,443,480)	(19,548,709)
	$ (106,209,323)	$ (134,442,181)

Avista would have an <u>annual additional tax benefit each year</u>, beginning in 2020, which would be available for immediate use to offset customers' rates estimated to be $16.4 million, shown in Table 6 below.

<u>Table 6</u>: Tax Benefit by Jurisdiction for Calendar 2020

Estimated Tax Impact of Basis Adjustments (IDD #5 and Meters) Annual Additional Amounts		
	ADFIT	Grossed-up for Federal Taxes
WA Electric	$ (5,179,775)	$ (6,556,678)
ID Electric	(2,789,110)	(3,530,519)
WA Natural Gas	(2,624,993)	(3,322,776)
ID Natural Gas	(1,124,997)	(1,424,047)
OR Natural Gas	(1,240,032)	(1,569,661)
	$ (12,958,907)	$ (16,403,679)

ADFIT is a reduction to rate base. If Avista was authorized to change to the flow-through method of accounting for certain basis adjustments, including IDD #5 and meters, and the tax benefits were to be given to customers over a shorter period than if using the normalization method, the ADFIT balance related to these basis adjustments would not be included in the rate base calculation as the amount would have already been flowed through to customers. Given this complexity, it is through a general rate case that the proposed modifications take place, with the benefit used to mitigate such rate filings and appropriately track changes in rate base and other accounts.

Avista has filed an accounting application with each jurisdiction (Oregon, Idaho and Washington) to change from the normalization method to the flow-through method of accounting for the IDD #5 and meters. The Company has asked to defer the deferred tax balance in a regulatory liability until the benefit can be passed back to customers in a general rate case proceeding. In addition, the tax benefits that are earned beginning in 2020 would also be deferred until that level of benefit is also built into customers' rates.

Because some costs that are included as IDD #5 and meters are common to all services and jurisdictions and because of limitations in the Company's tax software system, the Company must maintain uniform tax accounting across its three state service territories. Therefore, all three states must approve the proposed change in accounting for the tax benefits it realizes from these two tax methods. Avista anticipates receiving approval from all three jurisdictions at this time, however, the benefits of the change cannot be used in any one state until approval has been obtained in all three states.

Again, because Avista needs approval in all three states and because the change impacts both tax credits and rate base, Avista plans to include this change in accounting for these tax credits in each state's next filed general rate case. It is for this reason the Company is requesting an order approving the Company's deferral application and change from the normalization method to the flow-through method of accounting for the IDD #5 and meters tax benefits from all three jurisdictions, on or before May 1, 2021.

V. DESCRIPTION OF BASIS ADJUSTMENTS INCLUDED IN PROPOSAL

During 2020, Avista worked with consultants from the Deloitte accounting firm on a tax review project. The outcome of this project was to modify its tax method for accounting for certain costs relating to meters and mixed service costs (IDD #5). This change allowed the Company to deduct costs for tax purposes that previously were capitalized, thereby reducing current federal income taxes owed to the IRS. This change was included with the 2019 tax return that was filed in October 2020.

IDD #5 relates to mixed services costs that are part of the capitalized book costs of utility property but can be capitalized to inventory. Mixed service costs are defined as service costs that are partially allocable to production or resale activities (capitalizable) and partially allocable to nonproduction or non-resale activities (deductible). Avista does not deviate from its financial statement treatment of mixed service costs for federal income tax purposes. An opportunity exists for Avista to change to an "other reasonable method" for allocating mixed service costs. This results in less indirect costs being capitalized to self-constructed assets for federal income tax purposes. The costs not capitalized to self-constructed assets are deducted currently. Inventory allocation and engineering costs are the main drivers.

Avista currently capitalizes and depreciates meters over 5 to 20 years for tax purposes and over 15 to 20 years for book purposes depending on the meter type. I.R.C. Section 162 allows a deduction for all ordinary and necessary expense paid or incurred during the taxable year in carrying on any trade or business. Treas. Reg Section 1.162-3(c) materials and supplies means tangible property that is used or consumed in the taxpayer's operations that is not inventory and that –

> (iv) Is a unit of property as determined under Section1.263(a)-3(e) that has an acquisition cost or production cost… of $200 or less.

The meter accounting method change allows Avista, for income tax purposes, to deduct meter costs instead of capitalizing them if the per unit cost is less than $200.

Each of the accounting method changes described above were evaluated under IRC § 481(a) which allowed Avista to take deductions for prior periods (catch-up deductions). The excess deferred income tax (EDIT) amount associated with this tax depreciation is also reclassified to the basis adjustment moving it from protected to non-protected. Attachment C details the amounts related to IDD #5 and meters that are available for flow-through to customers at December 31, 2020.

The change in accounting methods discussed above were included in the Company's 2019 federal income tax return that was filed in October 2020, but will be reviewed by the IRS during a future audit of the Company's tax returns. The Company does not expect the calculations to materially change due to future review by the IRS, however, if any adjustments are made by the IRS, those amounts would result in adjustments to the amounts available to be flowed through to customers through the deferral.

VI. <u>PROPOSED ACCOUNTING TREATMENT</u>

The Company has provided the accounting entries that reflects the impact of changing from using the normalization method for certain basis adjustments to the flow-through method in Attachment D. A high-level summary of those accounting entries follows.

Avista will record the 2019 tax return adjustments and all future monthly tax accruals using the normalization method, until the Company receives approval to change to the flow-through method in all three states. This allows the Company to continue to record deferred taxes and will increase the ADFIT balance recorded in FERC Account No. 282900.

After the Company receives approval from all three states to utilize the flow-through method of accounting for the basis adjustments described above, the Company will record the amounts that have accumulated at that point related to those basis adjustments to FERC Account No. 254.3 – Regulatory Liability at the grossed-up amount. Associated deferred taxes will be recorded on this deferral in FERC Account No. 190 – ADFIT. The net of these two accounts will equal the amount that had been recorded in FERC Account. No. 282900 and will be included as an offset to rate base until flow-through begins. This will allow customers to continue to receive the benefits of the basis adjustments, as a reduction to rate base, until such time the flow-through benefits are included in rates.

As a part of the Company's next filed general rate case, the Company will propose the return of the accumulated tax credits recorded in FERC Account No. 254.3 taking into consideration the impact of any proposed change in base rates. Once those credits are being returned to customers, the Company will amortize the accumulated tax credits recorded in the regulatory liability account as approved by the Commission, until such time that the regulatory liability has been zeroed-out.

The Company is also proposing to defer the future annual benefits of these two basis adjustments to ensure the customer receives all the benefits from the flow-through.

VII. REQUEST FOR RELIEF

WHEREFORE, Avista respectfully requests that the Commission issue an Order approving Avista to change in its accounting for federal income tax expense from a normalization method to a flow-through method for certain plant basis adjustments, including Industry Director Directive No. 5 (IDD #5) and meters, and to defer the benefits associated with these changes for future return to customers. Once approved, the impact on federal income tax expense and ADFIT, which is a component of rate base, would be included in a future general rate case.

DATED this ______ day of October 2020.

Respectfully submitted,

Avista Corporation

By ____________________________________

Patrick Ehrbar

Director of Regulatory Affairs

Avista Corp