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IDAHO PUBLIC
UTILITIES COMMISSION

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION)
OF IDAHO POWER COMPANY FOR)
AUTHORITY TO INCREASE ITS INTERIM) CASE NO. IPC-E-03-13
AND BASE RATES AND CHARGES FOR)
ELECTRIC SERVICE.)

IDAHO POWER COMPANY
DIRECT REBUTTAL TESTIMONY
OF
BRUCE E. MACMAHON

1 Q. Please state your name and business address.

2 A. My name is Bruce E. MacMahon and my business
3 address is 350 N. Mitchell Street, Boise, Idaho 83704.

4 Q. What is your educational background?

5 A. I graduated from Saint Mary's College in
6 Moraga, California in 1983, receiving a Bachelor of Business
7 Administration Degree in Accounting. Since that time, I
8 have participated in numerous training courses related to
9 industry, taxation, management and leadership, as well as
10 developed course material and provided instruction on
11 technical business taxation topics. I became a licensed
12 Certified Public Accountant in the State of Idaho in 1987.
13 I have been an active member of the Tax Committee of the
14 Edison Electric Institute, Tax Executives Institute, and
15 served as a board member of the Idaho Society of CPA's
16 Southern Idaho Chapter, and as a board member of the
17 Associated Taxpayers of Idaho.

18 Q. Please outline your business experience.

19 A. I have worked in government and industry
20 since graduating from college in 1983. I initially worked
21 at the Federal Energy Regulatory Commission as a Financial
22 Auditor, taking part in a number of audits of regulated
23 utility companies, including Idaho Power. In 1984 I joined
24 the Boise Cascade Corporation as a Tax Analyst and Research
25 Supervisor until 1996, at which time I joined the Idaho

1 Power Company as the Tax Research Coordinator. In 1999, I
2 became the Corporate Tax Director for Idaho Power Company
3 and remained so until November of 2003 when I became Chief
4 Financial Officer for IDACOMM, Inc.

5 Q. In your position as Corporate Tax Director
6 for Idaho Power Company were you responsible for the filing
7 of the income tax returns for Idaho Power Company with the
8 Internal Revenue Service and the state tax agencies for the
9 tax years 2001 and 2002?

10 A. Yes.

11 Q. Did you participate in and are you familiar
12 with the income tax calculations that are presented in Idaho
13 Power's direct case in this proceeding?

14 A. Yes.

15 Q. Have you reviewed Mr. Holm's testimony as it
16 relates to the adjustments proposed by Staff for income
17 taxes?

18 A. Yes.

19 Q. Do you believe that Staff's income tax
20 proposals are reasonable and should be implemented by the
21 Idaho Public Utilities Commission for purposes of
22 determining Idaho Power's revenue requirement in this
23 proceeding?

24 A. No. Staff's approach ignores the computation
25 of the applicable tax base and instead applies a five-year

1 average ratio to the pre-tax rate case income. This
2 approach (1) ignores what is uniquely taxable or deductible
3 under current income tax law, (2) it ignores enacted income
4 tax rates, and (3) it ignores the distinction between
5 normalized income tax adjustments and flow-through income
6 tax adjustments, sweeping away years of carefully maintained
7 regulatory process, principles, and orders.

8 Q. Please explain how Idaho Power prepared the
9 income tax calculations that are presented in its direct
10 case.

11 A. First, current federal income tax is
12 calculated. The starting point is "income before tax
13 adjustments" (or pre-tax operating income). Deductible
14 interest expense computed using rate case concepts (interest
15 synchronization) is subtracted from pre-tax operating income
16 to arrive at "net operating income before taxes". Federal
17 income tax temporary and permanent adjustments, known as
18 "book-to-tax" or "M-1" adjustments, are added or subtracted
19 from net operating income before taxes to produce what is
20 commonly known as the federal tax base. The federal tax
21 base is reduced by the current state income tax deduction to
22 arrive at federal taxable income. Federal taxable income is
23 multiplied by the statutory corporate federal tax rate of
24 35% to arrive at the current federal income tax liability.
25 Added to the test year's current federal income tax were

1 federal deficiencies paid in 2003 for Idaho Power's 1998-
2 2000 Internal Revenue Service examination.

3 Second, current Idaho, Oregon, and other state
4 income taxes are computed. The starting point for each
5 calculation is the federal tax base. From that point
6 various state tax adjustments are made to arrive at the
7 state tax base. For Idaho, the federal deduction for bonus
8 depreciation is added back. The result is the Idaho state
9 income tax base, which is multiplied by 5.9%. The 5.9% rate
10 is Idaho's statutory corporate tax rate of 7.6% multiplied
11 by Idaho Power's state of Idaho apportionment factor of 78%,
12 which is consistent with the methodology set forth in
13 Commission Order 17499 (p. 13). The resulting Idaho state
14 tax is reduced by Idaho Power's current Idaho Investment Tax
15 Credit to yield the current Idaho state income tax
16 liability. For Oregon, a depreciation adjustment is also
17 added back. The result is Oregon's tax base, which is
18 multiplied by .3%. The .3% is Oregon's statutory corporate
19 tax rate of 6.6% multiplied by Idaho Power's state of Oregon
20 apportionment factor of 5%. The result is the current
21 Oregon state income tax liability. The other states
22 calculation starts with the same base as Idaho multiplied by
23 a blended rate of .1%.

24 Third, the provision for deferred income taxes is
25 computed by multiplying the normalized temporary book-to-tax

1 differences from the current income tax calculation by the
2 applicable statutory income tax rate. The resulting
3 deferred income tax expense is also the net annual change to
4 the accumulated deferred income taxes component of rate
5 base.

6 Finally, the investment tax credit component of
7 income tax expense is computed by combining the current year
8 amortization of federal and Idaho deferred investment tax
9 credits with the current year deferral of Idaho investment
10 tax credit earned.

11 Q. Are you familiar with the terms
12 "normalization" and "flow-through" as those terms are used
13 to reflect income tax adjustments in public utility revenue
14 requirement cases?

15 A. Yes.

16 Q. Please provide to the Commission a definition
17 of normalization and flow-through as those practices would
18 be reflected in Idaho Power's revenue requirement.

19 A. These two terms refer to two distinct methods
20 of computing income tax expense in a regulatory proceeding.
21 Using a normalization method to compute income tax expense
22 simply means that all of the income tax costs related to
23 items in the current period will be computed, whether paid
24 in the current year or paid later. This method creates
25 deferred income tax expense and the associated accumulated

1 deferred income tax liability that is subtracted from rate
2 base. The flow-through method of computing income tax
3 expense will take into account only those taxes that will be
4 paid in the current year, and does not create deferred
5 income tax or add to accumulated deferred income taxes on
6 the balance sheet.

7 Unless a book-to-tax adjustment is permanent, it is
8 considered temporary, meaning that the item will reverse in
9 a future period. A normalized book-to-tax difference is a
10 temporary difference that for accounting purposes adjusts
11 current income tax expense and has an equal offset in
12 deferred income tax expense, thus the net effect to total
13 book income tax expense is zero. A flow-through book-to-tax
14 difference is also a temporary difference that adjusts
15 current income tax expense, but does not have an offsetting
16 deferred income tax expense amount.

17 For example, if a flow-through adjustment is a
18 deduction, current income tax is reduced and with no
19 deferred income tax offset, book income tax expense is lower
20 than if the adjustment were normalized. Flow-through is a
21 regulatory accounting concept only. Generally Accepted
22 Accounting Principles ("GAAP"), under Financial Accounting
23 Standard Board Statement No. 109 ("FASB 109"), require that
24 deferred income taxes be recognized for all temporary
25 differences.

1 In its test year regulatory income tax expense
2 calculations, Idaho Power identified both its normalized and
3 flow-through book-to-tax adjustments. The total system
4 flow-through adjustments in the test year are a net \$21.2
5 million deduction. This net deduction reduces current
6 income tax expense by \$8.3 million.

7 Q. Is Idaho Power considered a flow-through
8 company for Idaho ratemaking purposes?

9 A. Yes, Idaho Power is a flow-through company
10 for ratemaking purposes. The only temporary book-to-tax
11 differences that receive normalized accounting treatment are
12 those provided by federal law.

13 Q. Please describe the normalized treatment
14 specified by federal law.

15 A. Temporary differences created by federal
16 accelerated and bonus depreciation and contributions-in-aid-
17 of-construction (CIAC) are excluded from flow-through
18 treatment by federal law (Internal Revenue Code §168(f)(2)
19 and Notice 87-82 respectively). A violation of the
20 normalization requirements in the federal tax law would
21 trigger a repayment obligation to the federal government of
22 previously accumulated deferred income taxes and the
23 forfeiture of accelerated tax depreciation methods to Idaho
24 Power in the future. Accordingly, the Company has provided
25 for deferred income taxes on these items in its regulatory

1 income tax expense at the federal statutory income tax rate.
2 The Commission has not normalized these items for state of
3 Idaho income tax purposes, thus the state effect of the
4 adjustment is flowed through to current income tax expense.

5 Q. Please explain the event that Mr. Holm refers
6 to as being the cause of the 2002 tax benefit.

7 A. The tax benefit that Mr. Holm refers to was
8 the result of an accounting method change adopted in Idaho
9 Power's 2001 federal income tax return.

10 Q. Please explain to the Commission why Idaho
11 Power made this accounting method change for tax purposes.

12 A. In early 2002, the IRS issued certain
13 technical changes in Revenue Procedures 2002-9, 2002-19, and
14 2002-54, and Announcement 2002-17 that made the method of
15 accounting change under Internal Revenue Code §263A and
16 associated Treasury Regulations possible for Idaho Power's
17 2001 tax return.

18 Idaho Power is required to capitalize certain
19 indirect costs under Internal Revenue Code §263A. Section
20 263A requires the capitalization of all direct costs and
21 those indirect costs, known as "mixed service costs", that
22 directly benefit or are incurred by reason of the production
23 of property. In its business, Idaho Power produces self-
24 constructed assets (plant), and electricity (inventory) for
25 sale to its customers.

1 The IRS ruled in Technical Advice Memoranda 9527003
2 that electricity is inventory for tax purposes. This
3 ruling, plus the changes to §263A, allowed Idaho Power to
4 allocate some of its mixed service costs to inventory, which
5 then became immediately deductible, due to electricity's
6 unique nature of real-time production and consumption. The
7 Company applied with the Internal Revenue Service to change
8 its method of accounting for capitalizing mixed service
9 costs with its 2001 federal income tax return, which it
10 filed in September 2002. Idaho Power followed the automatic
11 accounting method change procedures authorized in Revenue
12 Procedure 2002-9 to properly apply for the change in method.

13 Idaho Power changed its previously allowable method
14 of accounting to a new allowable method using the simplified
15 service cost method of §1.263A-1(h) with the production
16 based allocation ratio in §1.263A-1(h)(5) to determine its
17 future capitalizable mixed service costs for inventory and
18 self-constructed assets.

19 Q. How did this accounting method change cause
20 such a large benefit in 2002?

21 A. When a taxpayer changes its method of
22 accounting for an item, it must compute the effect the
23 change would have had on prior tax years had the method been
24 utilized. This is done pursuant to §481(a) of the Internal
25 Revenue Code. A "§481(a) adjustment" will either result in

1 a decrease (negative) or an increase (positive) to the
2 taxpayer's taxable income. Idaho Power's adjustment was
3 negative. The adjustment was computed by applying the new
4 method to the mixed service costs incurred by Idaho Power
5 during the years 1987-2000. Following Revenue Procedure
6 2002-19, Idaho Power was allowed to recognize its negative
7 §481(a) adjustment in the tax year of change, 2001, thus
8 creating a one-time single-year tax deduction, which was
9 recorded on the Company's books in 2002.

10 Q. As the individual responsible for the filing
11 of Idaho Power's income tax returns in the year 2002 for the
12 tax year 2001 did Idaho Power amend any prior tax returns
13 when it filed its 2001 income tax returns in 2002?

14 A. No, for income tax and accounting purposes
15 the one-time §481(a) adjustment created by the method change
16 is considered a 2001 adjustment, therefore no prior year
17 returns were amended, nor would the tax authorities allow
18 them to be amended for this purpose.

19 Q. Does the 2003 test year include any benefits
20 related to the method change?

21 A. Yes, the 2003 test year regulatory income tax
22 expense includes a total system \$14.3 million flow-through
23 tax deduction. The deduction reduced current income tax
24 expense by \$5.6 million. Had Idaho Power not initiated the
25 method change, customers would not be realizing this benefit

1 in the 2003 test year.

2 Q. Could you please describe your understanding
3 of the proposals for income tax adjustments that the Staff
4 has made in this proceeding?

5 A. Certainly. Staff has proposed to compute
6 Idaho Power's income tax expense by using an average ratio
7 of Idaho Power's actual above-the-line income tax expense as
8 a percentage of actual pre-tax book income for each of the
9 past five years added together and then divided by five.

10 Specifically, Staff has developed a hybrid income
11 tax rate concept by taking each of the last five years
12 including the test year and averaging the ratio of total
13 income tax expense (current tax, deferred tax, and ITC) for
14 each year over the total pre-tax book income for each year.
15 The resulting ratio for each year was added up and divided
16 by five to arrive at an average ratio that applied to the
17 previous five years. This average ratio was applied to
18 regulatory pre-tax income and labeled "current tax".

19 Staff's hybrid ratio was used to value the current
20 change in normalized temporary differences for deferred
21 income tax expense, without regard to the beginning balance
22 in accumulated deferred income taxes having been previously
23 established using enacted tax rates.

24 This hybrid ratio was used by Staff to compute the
25 net-to-gross tax multiplier to set new revenue requirement

1 to a pre-tax revenue value, without regard to the actual
2 income taxes the Company will pay on these new revenues.

3 Additionally, Staff has taken Idaho Power's 1998-
4 2000 Internal Revenue Service examination deficiency payment
5 included in the test year income tax expense and reduced it
6 by two-thirds on the theory that the payment is for a three-
7 year settlement and should be amortized accordingly.

8 Q. Please explain your understanding of the
9 computations that Staff made utilizing their five-year
10 hybrid tax ratio.

11 A. As I previously discussed, Staff has averaged
12 Idaho Power's above-the-line effective income tax rate for
13 the previous five years rather than looking to the statutory
14 income tax rates that Idaho Power is subject to. Staff then
15 used their average rate to recompute current and deferred
16 income tax, and reset the net-to-gross multiplier.

17 Staff has taken a very simplistic view of the income
18 tax calculations in the test year. It would appear that
19 their primary motivation for developing the five-year
20 average rate is to take advantage of Idaho Power's
21 abnormally low effective income tax rate in 2002. The cause
22 of the low income tax rate was a non-reoccurring deduction
23 for an accounting method change adopted in the 2001 federal
24 income tax return. When I removed the benefit for the non-
25 reoccurring deduction from the 2002 effective income tax

1 rate and recomputed the five-year average ratio it came out
2 to 39.19%. This happens to be extremely close to Idaho
3 Power's federal and state combined statutory income tax rate
4 of 39.10%.

5 Q. Mr. Holm stated in his testimony that by
6 using an average effective income tax rate Staff is
7 "...looking forward instead of backward." Do you agree?

8 A. No. By using this five-year hybrid ratio of
9 income tax expense to pre-tax book income, Staff is looking
10 backward to seize a portion of a non-reoccurring flow-
11 through deduction claimed in the 2001 income tax return and
12 then assumes that it could somehow be repeated to set future
13 rates.

14 Q. Is Staff's proposed computation an
15 appropriate way to compute income tax expense for revenue
16 requirement purposes in this proceeding?

17 A. No. As a theoretical method of reimbursing
18 income tax expense, the Staff's computation bears no direct
19 relationship to the income taxes a company will pay in the
20 future, unless every single variable that produced the ratio
21 in the past five years could somehow repeat itself in a
22 single year, which is quite impossible. Staff's approach
23 confuses the basic formula for computing income tax expense:
24 the income tax base times the currently enacted income tax
25 rates. The Commission's approved method has always been to

1 compute the applicable tax base (taxable income) and then
2 apply the currently enacted income tax rates to that base.
3 As I have previously stated, Staff's approach ignores the
4 computation of the applicable tax base and instead applies a
5 five-year average ratio to the pre-tax rate case income.
6 This approach (1) ignores what is uniquely taxable or
7 deductible under current income tax law, (2) it ignores
8 enacted income tax rates, and (3) it ignores the distinction
9 between normalized income tax adjustments and flow-through
10 income tax adjustments, sweeping away years of carefully
11 maintained regulatory process, principles, and orders.

12 An example is helpful to illustrate this point.
13 Assume Idaho Power earns \$100 in Year 1 and claims a \$5
14 repair allowance deduction on its income tax return, paying
15 federal income tax of \$33.25 ($\$95 \times 35\%$). The effective tax
16 ratio is 33.25%, while the statutory tax rate remains at
17 35%.

18 Assume further that Idaho Power makes \$150 in year 2
19 and claims another \$5 repair deduction on its annual income
20 tax return, paying federal income tax of \$50.75 ($\$145 \times$
21 35%). If the Commission were to use the prior year's
22 effective tax ratio to reimburse the Company for its Year 2
23 income tax expense, the Company would receive only \$49.88
24 ($\$150 \times 33.25\%$). The Company would be left short by \$0.87
25 ($\$50.75 - \49.88). The overall effect of Staff's approach

1 when applied within the context of the current rate
2 proceeding has an effective decrease to revenue requirement
3 in the millions of dollars. Clearly, this is a significant
4 issue to Staff's case.

5 Q. Staff has suggested that blending the rates
6 between years "...provides a more realistic basis for tax
7 expense over time". Do you agree?

8 A. As noted above, the effective tax ratio has
9 relevance only inside a single year, due to its
10 interdependence upon book income as its denominator. Since
11 it would be a mathematical impossibility to have a test year
12 mirror all the conditions that gave rise to the previous
13 year's tax ratio, let alone five previous years ratios
14 averaged together, there is no possibility of accurate or
15 even reasonable income tax recovery.

16 Mr. Holm also notes that the adjustments that
17 historically have gone into Idaho Power's calculation of
18 taxable income can be either stable or change dramatically,
19 year over year. Mr. Holm concludes that because of this
20 reality, the Company's effective income tax rates vary from
21 year to year. This is only half true. The other half is
22 that book income is also varying widely from year to year,
23 and as previously noted, has been generally lower than the
24 test year operating income due to drought conditions. A low
25 book income with large flow-through deductions for the

1 method change and repair allowance in the tax calculation
2 has resulted in unprecedented low tax ratios.

3 Q. Is Staff's amortization of the Internal
4 Revenue Service tax deficiency payment appropriate?

5 A. No. Staff's proposal is not consistent with
6 Commission Order 17499 (p. 24) where the Commission ordered
7 that income tax contingencies would not be allowed in
8 determining the test year regulatory income tax expense but
9 that any income tax deficiencies actually paid in the test
10 year should be included in regulatory income tax expense.
11 Idaho Power has settled and paid tax deficiencies in its two
12 previous audit cycles that were not in test years (1993-95,
13 paid in 1998 and 1996-97 paid in 2000) and has not included
14 these deficiencies in the 2003 test year in accordance with
15 the Commission's previous order. The test year tax expense
16 includes only the amounts paid in the current test year, at
17 100%, not 33%.

18 Q. Would Staff's hybrid income tax ratio
19 proposal violate the requirements of the Internal Revenue
20 Code as it relates to normalization vs. flow-through?

21 A. Yes, it would. By applying Staff's five-year
22 hybrid tax ratio to deferred income taxes, Mr. Holm has
23 caused the current year change for accelerated depreciation
24 to be valued at something other than the statutory rate.
25 This violates the normalization requirement of Internal

1 Revenue Code §168(f)(2).

2 Q. Please explain the effect of the use of
3 Staff's hybrid tax ratios on the Company's deferred income
4 tax balances.

5 A. Mr. Holm reduced deferred income tax expense
6 by using Staff's five-year hybrid tax ratio on the current
7 year change to temporary differences, while disregarding the
8 fact that the beginning balance in accumulated deferred
9 income taxes has been recorded using statutory income tax
10 rates. Setting aside the resulting issue of triggering a
11 normalization violation, another deficiency in the Staff's
12 proposal is that the accumulated deferred income taxes would
13 need to be recomputed using the five-year hybrid tax ratio.
14 Following Staff's proposal, the recomputed reserve for
15 deferred income taxes would increase the Company's rate base
16 by approximately \$53 million as the net deferred tax
17 liability balance would drop due to the application of the
18 lower rate.

19 Q. Does Staff's use of a net-to-gross tax
20 multiplier that is based upon their proposed five-year
21 hybrid tax ratio adequately reimburse Idaho Power for the
22 income taxes it will pay on the new revenue received from
23 customers?

24 A. No. By using the five-year hybrid tax ratio,
25 Staff is assuming that the same ratio of average income tax

1 to average pre-tax book income will apply to the new revenue
2 deficiency dollars paid by customers. The federal and state
3 governments will not recognize this ratio when Idaho Power's
4 income tax returns are filed that contain these new revenue
5 dollars. Instead, the governments will apply the statutory
6 income tax rates to these new revenue dollars. Staff's
7 proposal leaves the Company far short of the cash needed for
8 its real income tax liabilities.

9 Q. Does this conclude your direct rebuttal
10 testimony in this case?

11 A. Yes, it does.