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INDIANA UTILITY
REGULATORY COMMISSION

SOUTHERN INDIANA GAS AND ELECTRIC COMPANY
d/b/a CENTERPOINT ENERGY INDIANA SOUTH
(CEI SOUTH)

DIRECT TESTIMONY
OF
1 **BENJAMIN D. VALLEJO**
2 **DIRECTOR, CORPORATE TAX**

ON

INCOME TAX REQUIREMENTS RELATED TO SECURITIZATION

SPONSORING PETITIONER'S EXHIBIT NO. 7,

ATTACHMENT BDV-1

DIRECT TESTIMONY OF BENJAMIN D. VALLEJO

1 **I. INTRODUCTION**

2

3 **Q. Please state your name, occupation, business affiliation, and business address.**

4 A. My name is Benjamin D. Vallejo. My business address is 1111 Louisiana Street,
5 Houston, Texas 77002. I am a Director, Corporate Tax for CenterPoint Energy, Inc., the
6 ultimate parent company of Southern Indiana Gas and Electric Company d/b/a
7 CenterPoint Energy Indiana South ("Petitioner," "CEI South," or the "Company")

8

9 **Q. What are your current responsibilities?**

10 A. My primary responsibilities include leading the income tax planning and strategy
11 and assisting the accurate reporting of the federal and state income taxes of
12 CenterPoint Energy, Inc. and its subsidiaries and business units, including CEI
13 South.

14

15

16 **Q. Please describe your educational background, as well as your business and**
17 **professional experience.**

18 A. I have over thirteen years of tax experience with an emphasis on federal and state
19 compliance, income tax accounting for financial reporting purposes, and tax
20 research and planning for publicly traded companies. I hold a Bachelor of Science
21 degree in Business Administration from Creighton University. I am a certified
22 public accountant.

23

24 From 2009 through 2014, I was employed at various utility and energy companies.
25 My primary responsibilities included working on the federal, state, and international
26 income tax compliance process, designing and advising on domestic and
27 international restructurings, and preparing calculations for the quarterly income tax
28 provision under Accounting Standards Codification Topic No. 740 ("ASC 740").
29 ASC 740 is a set of financial accounting and reporting standards for the effects of
30 income taxes that result from a company's activities during the current and

preceding years. Its primary objective is to recognize the amount of taxes payable or refundable for the current year and the deferred tax assets and liabilities relating to the future tax consequences of events that have been recognized in a company's financial statements or tax returns. From 2014 through 2017, I was employed by PricewaterhouseCoopers working in its international tax services group. In this role I advised clients primarily engaged in the energy sector on the consequences of certain cross-border transactions, as well as assisted in their provision and compliance processes from an international perspective. From 2018 to March 2020, I worked at Tellurian Inc. In this role I was responsible for the compliance and provision processes, the filing of certain other non-income tax returns (*e.g.*, property tax, sales tax, *etc.*) and advising management on the structuring and tax consequences of certain transactions. In 2020, I joined Service Company as a Tax Manager primarily responsible for the tax planning, in addition to assisting in the federal income tax compliance and provision processes. In August of 2021, I was promoted to Tax Director overseeing tax planning and strategy, as well as overseeing certain parts of regulatory filings.

Q. On whose behalf are you testifying in this proceeding?

A. I am testifying on behalf of CEI South.

Q. Have you previously testified before the Indiana Utility Regulatory Commission (the "Commission") or any state regulatory commission?

A. No.

II. PURPOSE AND SCOPE OF TESTIMONY

Q. What is the purpose of your testimony?

A. CEI South is securitizing the majority of Qualified Costs, including the remaining book value, of its coal-fired A.B. Brown Generating Station Units 1 and 2 (the "Brown Units 1 and 2"). In connection with the securitization, my testimony addresses the specific income

1 tax requirements that must be complied with in order for the initial net securitization bond
2 proceeds to be non-taxable. Such requirements are contained in IRS Revenue Procedure
3 ("Rev Proc") 2005-62, provided as Petitioner's Exhibit No. 7, Attachment BDV-1. I also
4 discuss the regulatory treatment of taxes related to the recovery of securitization charges.
5
6 **Q. Are you sponsoring any attachments with your testimony?**
7 A. Yes/No, I am sponsoring the following attachments:
8
- Petitioner's Exhibit No. 7, **Attachment BDV-1**: IRS Rev Proc 2005-62

9
10
11 **III. DESCRIPTION OF THE SECURITIZATION TRANSACTION**
12
13 **Q. Please briefly describe the securitization transaction.**
14 A. The Company will be shutting down its Brown Units 1 and 2 prior to recovering, through
15 depreciation, the book value of such facilities. Instead, the Company will be transferring
16 the net book value of these units from the plant accounts to a special purpose, bankruptcy
17 remote, subsidiary that will issue securitization bonds to third party investors. The net
18 securitization bond proceeds will be paid, in turn, to the Company who will record a
19 regulatory asset, representing an approved revenue stream that will be charged to and
20 collected from utility customers over 15 years.
21
22 As the revenues are collected from utility customers, they will be used to make principal
23 and interest payments on the securitization bonds and pay other ongoing costs.
24
25 The primary advantage of this process is that the securitization bonds can be issued at a
26 favorable interest rate, reducing the customer payments necessary to recover the
27 remaining net book value of the facilities. The interest rate obtained for secured financing
28 is generally advantageous to market rates, and thus results in lower costs to customers,
29 because the financing is secured by a bankruptcy-remote future revenue stream
30 (amortization of the regulatory asset) assigned to repay the securitization bonds.
31
32 **Q. Are securitizations common in the utility industry?**

1 A. Yes. As explained in more detail by Petitioner's Witness Eric K. Chang, securitizations
2 have been used for potentially stranded costs in connection with electric industry
3 deregulation occurring in several jurisdictions in the late 1990's and early 2000's. In
4 addition, they have been used to recover unusual, significant operating costs due to
5 weather. For instance, the extraordinary costs of Winter Storm Uri have been securitized
6 in a number of jurisdictions.
7
8 **Q. Have securitizations previously been used by CenterPoint Energy, Inc.?**
9 A. Yes, as Petitioner's Witness Brett A. Jerasa testifies, CenterPoint Energy Houston
10 Electric, LLC ("CEHE"), an affiliate of CEI South, has issued securitization bonds in the
11 past to recover certain stranded costs and regulatory assets as well as costs related to
12 restoring the utility's distribution system following Hurricane Ike.
13
14
15 **IV. <u>INCOME TAX CONSEQUENCES OF SECURITIZATIONS</u>**
16
17 **Q. What are the income tax consequences of securitizations?**
18 A. There are several potential income tax consequences. First, a taxable loss would result
19 from any remaining tax basis existing at the time the units are shut down.
20
21 Second, the net securitization bond proceeds could potentially be taxable, but as I will
22 discuss, will not be taxable if the Safe Harbor rules outlined in Rev Proc 2005-62 are
23 complied with. Finally, the revenue collected from the customers and remitted to the
24 bondholders for principal and interest represent potentially taxable events.
25
26 **Q. Has the IRS provided guidance on securitizations?**
27 A. Yes. As I stated, the IRS has issued specific "safe harbor" guidance addressing
28 securitization transactions in Rev Proc 2005-62. If this guidance is followed, the net
29 securitization bond proceeds are not taxable. The IRS had previously issued securitization
30 guidance in Rev Proc 2002-49 that addressed securitizations authorizing electric utilities
31 to recover transition costs resulting from electric industry deregulation/restructuring when
32 certain states enacted legislation allowing for transition cost recovery through a
33 nonbypassable customer surcharge. Subsequently, a number of jurisdictions that

1 continue to operate under rate base/cost of service regulation allowed a similar
2 securitization surcharge approach permitting utilities to recover other significant costs
3 (storm costs for example) unique to the industry. In Rev Proc 2005-62, the IRS expanded
4 the scope of Rev Proc 2002-49 from only pertaining to deregulation/electric industry
5 restructuring to other events in which a utility is permitted a consumption-based cost
6 recovery surcharge with a securitization of such surcharge.
7
8 **Q. What are the requirements enumerated in Rev Proc 2005-62 that must be complied**
9 **with in order for the securitization proceeds to be non-taxable?**
10 A. The Rev Proc 2005-62 requires that pursuant to "specified cost recovery legislation," the
11 utility receives an irrevocable financing order from an appropriate State agency that
12 determines the amount of certain specified costs the utility will be permitted to recover
13 through qualifying securitization of an intangible property right created by the special
14 legislation. "Specified cost recovery legislation" under Rev Proc 2005-62 is legislation that:
15 1) Is enacted by the State facilitating the recovery of specified costs incurred by the
16 utility;
17 2) Allows the utility to apply for and authorizes the regulatory or other State agency
18 to issue a financing order specifying the amount of costs to be recovered;
19 3) Allows the utility an intangible property right to charge and collect the full recovery
20 of the recoverable costs with such charges being nonbypassable and paid for by
21 customers receiving transmission and distribution service, even if customers have
22 chosen to receive service from another provider;
23 4) Guarantees that, except for contemplated adjustments authorized by the specific
24 legislation, neither the State nor any state agencies can rescind/amend the
25 financing order, revise amounts or otherwise impair the value of the intangible
26 property right;
27 5) Provides procedures to transfer the intangible property right to a Special Purpose
28 financing entity wholly owned by the utility in such a way that equity interests in the
29 financing entity are at least 0.5% of the aggregate principal amount of the non-
30 equity instruments issued and such transfer will be perfected under State law; and
31 6) Authorizes the securitization through the issuance of bonds, notes or other
32 evidence issued by the utility or a financing entity that is wholly owned by the utility
33 (directly or indirectly).

Q. Can you state how the above conditions have been complied with in the CEI South transaction?

A. Yes.

Q. How has the first condition, obtaining enabling legislation, been met?

A. Senate Enrolled Act No. 386 (codified at Ind. Code ch. 8-1-40.5, the "Securitization Act") has been passed, providing the legislative authorization for the securitization proposed in this case.

Q. How has the second condition, authorizing the utility to seek and regulatory commission to issue a financing order, been met?

A. Indiana Code § 8-1-40.5-10 sets forth the requirements for a utility to seek authority to issue securitization bonds, collect securitization charges, and encumber securitization property with a lien and security interest under Ind. Code § 8-1-40.5-15. Section 10 of the Securitization Act also provides legislative authority for the Commission to issue the required financing order.

Q. Please explain your understanding of the third requirement, providing CEI South an intangible right to collect specified costs from CEI South customers through a nonbypassable surcharge.

A. The Securitization Act enables a public utility to use securitization to recover "qualified costs" associated with the retirement of an electric generation facility to be retired from service no later than twenty-four (24) months after the filing of a petition by the electric utility under Indiana Code § 8-1-40.5-10. The Qualified Costs are recovered through securitization charges approved by the Commission. The securitization charges are irrevocable and not subject to reduction, impairment, or adjustment by further action of the Commission except as provided in Ind. Code § 8-1-40.5-10(h) and Ind. Code § 8-1-40.5-12(c). The securitization charges are nonbypassable and must be paid by all customers and customer classes of the electric utility.

With this filing, CEI South is seeking, among other relief, authority to issue securitization bonds, collect securitization charges, and encumber securitization property with a lien and

1 security interest pursuant to Ind. Code ch. 8-1-40.5. Petitioner's Witness Brett A. Jerasa,
2 provides a summary of the Qualified Costs that Petitioner seeks to recover through
3 issuance of securitization bonds in this Cause, a component of which is the remaining net
4 book value of the retiring assets as of February 28, 2023.
5
6 **Q. Please explain how the fourth requirement that the financing order and intangible**
7 **property right (also referred to as securitization property) are irrevocable and will**
8 **not be rescinded, amended, or otherwise impaired is satisfied.**
9 A. The State of Indiana has pledged it will not take or permit any action that impairs the value
10 of securitization property or reduces, alters (except as provided in Ind. Code § 8-1-40.5-
11 12(c)) or impairs securitization charges to be imposed, collected, and remitted to financing
12 parties under Ind. Code ch. 8-1-40.5 until the principal, interest, and premium, and other
13 charges incurred, or contracts to be performed, in connection with the related
14 securitization bonds have been paid or performed in full. Ind. Code § 8-1-40.5-16(b). The
15 Securitization Act provides for a similar pledge from the Commission that the securitization
16 bonds and securitization charges are irrevocable and not subject to reduction, impairment
17 or adjustment by further action of the Commission except for the review and adjustment
18 of securitization charges provided by Ind. Code § 8-1-40.5-12(c). Ind. Code § 8-1-40.5-
19 10(f), (g), and (j).
20
21 **Q. Do procedures exist for the intangible property right created in this securitization**
22 **to be transferred to a special purpose financing entity?**
23 A. Yes. Under Ind. Code § 8-1-40.5-15, the intangible property right transferred to the special
24 purpose financing entity cannot be rescinded or altered. Also, Petitioner's Witness Jerasa
25 has testified that CEI South expects to contribute an amount equal to 0.5% of the initial
26 aggregate principal amount of securitization bonds issued as a capital contribution to the
27 special purpose entity. This is being done to satisfy this safe harbor provision within the
28 revenue procedure.
29
30
31 **Q. Finally, has the sixth component related to authorizing the securitization through**
32 **the issuance of bonds by CEI South or a CEI South wholly owned financing entity**
33 **been satisfied?**

1 A. Yes, as described in further detail by Petitioner's Witness Jerasa, upon issuance of a
2 Financing Order in this Cause, CEI South will form a new special purpose entity to issue
3 the securitization bonds and receive the net securitization bond proceeds.
4
5 **Q. What is your conclusion regarding whether CEI South has complied with the safe**
6 **harbor requirements of Rev. Proc 2005-62?**
7 A. CEI South has complied with the safe harbor requirements of Rev Proc 2005-62. As a
8 result, the net bond proceeds from the securitization should be non-taxable.
9
10
11 **V. INCOME TAX ACCOUNTING AND RATEMAKING FUNDAMENTALS**
12
13 **Q. Before describing the income tax treatment of the Securitization, please discuss**
14 **income tax accounting in general and for rate regulated entities like the company.**
15 A. Accounting for income taxes under GAAP is addressed in section ASC 740 (formerly
16 SFAS No. 109, Accounting for Income Taxes (SFAS 109)) of the accounting codification.
17 There are several components to the calculation: currently payable income taxes; deferred
18 income taxes; and investment tax credit. My testimony will only focus on the first two
19 components as the investment tax credit is not an issue in this case. There is no remaining
20 investment tax credit related to the Brown Units 1 and 2, and so that is why no investment
21 tax credit has been included in the Qualified Costs. Also, my descriptions will focus on
22 federal currently payable income taxes and federal deferred income taxes, although the
23 same basic explanation would apply to relevant state income taxes.
24
25 **Q. Please describe the first component, currently payable income taxes.**
26 A. Currently payable income tax expense represents the estimated amount of current year
27 income taxes payable to the U.S. Treasury as reflected on the Company's income tax
28 return based on current year taxable income determined in accordance with the Internal
29 Revenue Code ("IRC"). For purposes of preparing an income tax return each year, the
30 IRC contains guidance for determining if and when an item is "taxable" or "deductible."
31
32 **Q. Are the taxable or deductible amounts under the IRC for determining IRC taxable**
33 **income the same as those used in determining revenue or expense under GAAP?**

A. No, not always. The IRC rules for determining what is taxable or deductible may differ from what is reportable as revenue, income or expense under GAAP. For instance, certain expenses recorded on the financial statements under GAAP in one year may be deductible on the tax return in a different accounting period. There are also instances where the amounts shown as deductions on the tax return in one year are not reflected on the financial statements until a later year. As a result, at the end of each reporting period, there will likely be accumulated differences on the book and income tax balance sheets of reported assets and liabilities resulting from different treatment for book accounting and tax return treatment of revenues, income and expenses. These differences are referred to as timing or temporary differences.

Q. Can you further explain what is meant by a timing or temporary difference and provide an example?

A. Yes. One common temporary difference which is particularly relevant for the securitization relates to the concept of depreciation. For book and financial reporting purposes, when a company acquires a fixed asset, GAAP requires that the asset be depreciated over its estimated useful life in a systematic and rational manner. In so doing, the cost of the fixed asset is "allocated" to the periods in which the fixed asset is being used to provide service. Most utilities depreciate their fixed assets for book purposes using the straight-line depreciation method under which the same depreciation expense amount is recorded each year of a fixed asset's estimated useful life.

In contrast to the straight-line depreciation method used for determining depreciation expense under GAAP, an accelerated depreciation method is commonly used for income tax purposes. Under an accelerated depreciation approach, that same fixed asset may be depreciated on the income tax return using an accelerated method (more than a straight-line method) and/or different (generally shorter) estimated useful life. When the annual depreciation charge for book purposes is compared to the annual depreciation for income tax purposes, there will likely be differences. In the early years of an asset's life, tax depreciation using an accelerated method and/or shorter lives generally will be greater than straight-line book depreciation. In the later years, the reverse will be true because given the same capitalized asset cost, the cumulative tax and book depreciation amounts over the entire life of the asset must equal. At any point during the life of the fixed asset,

1 the sum of the annual book-tax depreciation differences results in accumulated book-tax
2 depreciation differences when comparing the net book value and net tax value of fixed
3 assets.
4
5 **Q. Can you provide an example of how the depreciation book tax difference arises**
6 **and reverses?**
7 A. Yes. Assume a utility acquires property, plant and equipment for $100 million cash. The
8 entry to record the asset is to debit property, plant and equipment and to credit cash. For
9 book purposes, assume that asset has a useful life of ten years. For income tax purposes,
10 assume that same asset qualifies as a five-year tax depreciation asset under the Modified
11 Accelerated Cost Recovery System ("MACRS" – an allowable approach under the IRC).
12 Under MACRS for a five-year asset, the asset is depreciated using double declining
13 balance, switching to straight line at the tax midpoint of its life. Thus, the depreciation
14 deduction is 20 percent the first year, 32 percent in year two, 19.2 percent in year three,
15 11.52 percent in years four and five and 5.76 percent in year six. The annual depreciation
16 charges for book and tax would be as follows:

Year	Book Depreciation	Tax Depreciation	Difference	Cumulative Book-Tax Difference
1	10,000,000	20,000,000	10,000,000	10,000,000
2	10,000,000	32,000,000	22,000,000	32,000,000
3	10,000,000	19,200,000	9,200,000	41,200,000
4	10,000,000	11,520,000	1,520,000	42,720,000
5	10,000,000	11,520,000	1,520,000	44,240,000
6	10,000,000	5,760,000	(4,240,000)	40,000,000
7	10,000,000		(10,000,000)	30,000,000
8	10,000,000		(10,000,000)	20,000,000
9	10,000,000		(10,000,000)	10,000,000
10	10,000,000		(10,000,000)	0
Total	100,000,000	100,000,000	0	

17
18 At the end of year 1, the net book basis of property, plant and equipment for book purposes
19 would be $90 million ($100 million gross plant, less $10 million of accumulated book

1 depreciation) while its tax basis would be $80 million ($100 million gross tax basis less
2 $20 million of accumulated tax depreciation). Each year's book depreciation expense
3 would increase Accumulated Depreciation, reduce the net book basis of property, plant
4 and equipment and each year's tax depreciation would affect the tax basis of property,
5 plant and equipment. The difference between the book basis and tax basis of property,
6 plant and equipment represents a temporary difference under ASC 740.
7
8 However, because total depreciation expense/deductions are limited to the gross
9 capitalized cost of the property, plant and equipment, accelerated income tax depreciation
10 claimed in the early years (reducing income tax payments) will reverse in subsequent
11 periods when book depreciation exceeds tax depreciation (increasing income tax
12 payments) such that when the asset is retired, the depreciation temporary difference will
13 have completely reversed (i.e., the same amount of depreciation will have been recorded
14 for both book and tax purposes).
15
16 **Q. What is the accounting for temporary differences under ASC 740?**
17 A. Under GAAP, because the financial statements reflect accrual, not cash basis accounting,
18 deferred income taxes are recorded on temporary differences. As a result, income tax
19 expense under GAAP includes both a currently payable component (as previously
20 described, based on the tax return) as well as a "deferred" income tax component (based
21 on timing/temporary differences). Such deferred income taxes reflect the liability or asset
22 for income taxes payable or receivable in the future stemming from transactions recorded
23 in the financial statements currently. The balance sheet liability or asset for future taxes
24 is Accumulated Deferred Income Taxes ("ADIT"). In other words, to the extent that
25 accelerated tax depreciation is claimed on the income tax return in an amount that
26 exceeds book depreciation reported on the financial statements (reducing the current
27 year's taxable income and tax obligation), a liability for future taxes results. The future tax
28 liability will be "paid" in later years when book depreciation exceeds income tax deductible
29 tax depreciation.
30
31 Under ASC 740, a calculation of required ADIT is performed at the end of each annual
32 reporting period. The required ADIT is measured by multiplying the temporary differences
33 by the currently applicable income tax rates. The difference obtained by comparing the

1 ADIT at the current balance sheet date to the ADIT at the previous balance sheet date
2 results in "deferred income tax expense." For regulated entities, the process of recording
3 deferred income taxes on temporary differences is referred to as "normalization," "deferred
4 tax accounting," or "comprehensive interperiod income tax allocation."
5
6 **Q. Please explain how current and deferred income taxes would be recorded on the**
7 **financial statements for the depreciation difference example you discussed**
8 **previously.**
9 A. In year 1 of the example, the Company would record depreciation expense on the books
10 in accordance with GAAP of $10 million. In that same year, they would reduce taxable
11 income on the income tax return by tax depreciation of $20 million. Assuming a 21 percent
12 income tax rate, by claiming a $20 million depreciation deduction, **current** taxes payable
13 and **current** tax expense would be reduced by $4,200,000 (21 percent income tax rate
14 times the $20 million tax depreciation deduction).
15
16 However, by claiming an additional $10 million of tax depreciation ($20 million tax
17 depreciation compared to $10 million of book depreciation) the Company will also record
18 a **deferred** income tax liability and **deferred** tax expense of $2,100,000 (21 percent
19 income tax rate times book/tax difference of $10 million). The deferred tax will become
20 payable when the book depreciation exceeds tax depreciation. In other words, by claiming
21 accelerated depreciation (compared to straight line book depreciation) in years 1-5, the
22 Company has incurred a deferred tax obligation that will become payable in years 6-10.
23
24 Thus, a timing or temporary difference that reduces current income tax expense and
25 current taxes payable is offset by an equal increase in deferred tax expense and ADIT.
26 When the timing or temporary difference reverses, current income tax expense and
27 current taxes payable will increase and be offset by a decrease in deferred income tax
28 expense and ADIT.
29
30 **Q. How are deferred income taxes treated in the ratemaking process?**
31 A. In the ratemaking process, revenue requirements are unaffected by such timing or
32 temporary differences (from the expense side) as the reduction (or increase) in current tax
33 expense is offset by an equal and offsetting increase (or reduction) of deferred tax

1 expense. In this manner, it should be noted that utility customers do not pay deferred
2 income taxes (there are equal and offsetting current and deferred expense amounts).
3 Instead, the source of such deferred income taxes is the U.S. Treasury. As a result, ADIT
4 balances are often characterized as an "interest free loan" from the U.S. Treasury. This
5 was the objective Congress intended when it enacted accelerated depreciation in the IRC.
6 Congress believed that allowing companies to increase their tax depreciation deductions
7 (and thereby reduce current income tax payments), would lower the financing costs of
8 their investment in capital assets more quickly and thus they would be incented to make
9 such expenditures.
10
11 **Q. Do regulators permit deferred income tax accounting for all book-tax temporary**
12 **differences?**
13 A. Not always. In certain jurisdictions, there is a concept known as "flow-through" under
14 which deferred income tax expense is not permitted as a recoverable cost in the
15 ratemaking process. In these situations, the reduction in current income tax stemming
16 from an originating tax deduction exceeding the related book accounting expense is
17 flowed-through to customers. Only current income tax expense is included in cost of
18 service. When income tax flow-through is used, when the book-tax difference reverses
19 (because it is a temporary difference it will reverse), current income tax expense is
20 increased and since there were no deferred income taxes provided, cost of service income
21 tax expense is increased.
22
23 **Q. Are there specific sections in the IRC that apply to public utility property and**
24 **discuss how timing/temporary differences should be treated in the ratemaking**
25 **process?**
26 A. Yes. The IRC provides guidance on how utilities and their regulators must treat certain
27 book-tax differences in the ratemaking process. This guidance is known as the
28 "normalization rules." The items addressed by the normalization rules are: deferred
29 income tax method and life depreciation differences (and certain contributions in aid of
30 construction); excess ADIT (caused by the change in the statutory income tax rate), and
31 investment tax credits ("ITC"). If the IRC guidance on how these items are to be treated
32 in the ratemaking process are not followed (such as flow-through of income taxes), the
33 Company will be prohibited from:

- claiming accelerated depreciation on future tax returns, not just for individual items of property, plant and equipment, but for all property, plant and equipment;
- claiming ITC on future tax returns.

In addition, the Company would be required to refund to the IRS, any remaining ITC recorded on its books. It is a severe penalty.

Because the IRC normalization rules must be followed when determining deferred taxes and ITC in rate cases in order for the utility to claim accelerated depreciation or ITC, they are "protected" book/tax differences. All other book-tax differences are "unprotected" with no requirements for rate case treatment included in the IRC.

Q. You said that the IRS normalization rules apply to protected book-tax differences and define protected book-tax differences as primarily due to differences between the book and tax depreciation methods and lives used in the calculations of book depreciation expense and tax-deductible depreciation. Are the rest of a company's book-tax timing/temporary differences considered unprotected?

A. Basically, yes. The normalization rules apply to protected book-tax differences, caused by different depreciation methods (accelerated depreciation for tax, straight-line depreciation for books) and depreciation lives (different, generally shorter lives for tax purposes). There are several other book-tax differences that are also considered protected, such as the book-tax difference associated with contributions in aid of construction and the appropriate treatment of Net Operating Loss ("NOL") Deferred Tax Assets. All other book-tax temporary/timing differences are considered unprotected and are not subject to the normalization requirements of the IRC. For example, rate case expense is deferred and amortized on the books, but a current income tax deduction is permitted for such expense in the year incurred/accrued.

Q. Is deferred income tax accounting appropriate for ratemaking purposes?

A. Yes. Income tax expense in a given year is the result of that year's economic activity. In determining the revenue requirement, it is important for regulatory commissions to consider the recovery of all appropriate costs of providing service (return, operating expense, maintenance expense, depreciation expense, etc.) and, after such pre-tax

1 amounts are determined, calculating the associated income tax effects of the recoverable
2 pre-tax amounts as virtually every cost of service component has an income tax
3 consequence. The sum of the two results in the permitted cost of service.
4
5
6 **VI. SECURITIZATION ACCOUNTING AND TAX CONSIDERATIONS**
7
8 **Q. Turning to the book and tax treatment of the securitization, can you please walk**
9 **through the accounting and income tax entries?**
10 A. Yes. As of February 28, 2023, a net book value and a tax basis will exist for the Brown
11 Units.

Line		Federal Tax	State Income Tax
12		Federal Tax	State Income Tax
13	Net Book Basis	$306,305,397	$306,305,397
14	Net Tax Basis	103,058,489	149,938,186
15	Temporary Difference	$203,246,907	$156,367,211

16
17 CEI South has recorded Accumulated Deferred Income Tax ("ADIT") related to the book-
18 tax temporary difference, predominantly related to accelerated depreciation. A portion of
19 the temporary difference has been flowed-through and, thus ADIT have not been
20 permitted in the ratemaking process. The temporary difference on which ADIT have been
21 recorded and the resulting ADIT is as follows:

Line		Federal Tax	State Income Tax
22		Federal Tax	State Income Tax
23	Temporary Difference per		
24	above:	$203,246,907	$156,367,211
25	Flow Thru Differences	2,347,607	2,350,866
26	Temporary Differences upon		
27	which ADIT is provided	$200,899,300	$154,016,345
28	Tax Rate	21%	4.9%
29	ADIT	$ 42,188,853	$ 7,661,993

30

A special purpose entity will issue securitization bonds to recover the remaining net book value of these facilities. As stated earlier in my testimony, the net securitization bond proceeds should be non-taxable. As the future revenue stream to pay debt service on the securitization bonds and other ongoing costs has been approved by the Commission as well as enabling legislation, this revenue stream (to recover the remaining book value of the Brown Units 1 and 2 over 15 years) is recorded as a regulatory asset by CEI South. The previously recorded ADIT continues to exist, however they are no longer "plant related". Instead, they relate to the regulatory asset and will reverse as the regulatory asset is amortized and collected through customer surcharges. This distinction is important in that non-plant related ADIT are not protected under the Internal Revenue Code ("IRC") normalization provisions contained in Section 168(i)(9) & (10).

VI. SECURITIZATION BOOK AND TAX ACCOUNTING

Q. What is the accounting for the billing and collection of the surcharge?

A. The accounting for the billing and collection of the surcharge follows traditional accounting. As revenues are billed:

Dr. Accounts Receivable	XXX	
Cr. Revenue		XXX
Dr. Amortization of Reg Asset	XXX	
Cr. Regulatory Asset		XXX

The revenue is taxable revenue.

As amortization of the regulatory asset is recorded (assuming that no remaining tax basis exists), the journal entry is:

Dr. ADIT (FERC USOA 283)	XXX	
Cr. Deferred Tax Expense (FERC USOA 411)		XXX

Q. Will there be net tax expense from the collection of the surcharge?

A. No. The receipt of the surcharge payments will be taxable, but will be offset in tax expense from the reversal of the ADIT as shown above as well as any current tax deduction on the interest payments being made on the securitization bonds. In this way, there should not

1 be a need to gross up the Securitization Charges for any incremental taxes to collect, as
2 there should not be incremental tax expense.
3
4 **Q. How are the bond principal and interest on the securitization bond proceeds**
5 **treated?**
6 A. As the securitization bond principal is repaid, the typical balance sheet entry (reducing
7 debt) is recorded. Interest expense is recorded and recovered as typically occurs. As
8 stated previously, interest on the securitization bonds is obtained at a favorable rate,
9 increasing the attractiveness of the securitization vehicle.
10
11 **Q. You mentioned that the ADIT related to the Brown Units being securitized no longer**
12 **are protected under the IRC normalization rules. What are the implications of this**
13 **change?**
14 A. There is a potential issue related to any excess ADIT for this book-tax temporary
15 difference. When the corporate income tax rate was reduced in 2017 upon enactment of
16 the Tax Reform and Jobs Act ("TCJA"), utility companies remeasured their ADIT balance
17 (established at income tax rates in excess of the newly enacted income tax rate—statutory
18 rate reduced from 35% to 21%)) and reclassified the excess to a regulatory liability
19 account. The reclassification was necessary to 1) state the ADIT at the current statutory
20 rate as required under GAAP and 2) establish a regulatory liability reflecting how (over
21 what period) the excess ADIT will be returned to utility customers.
22
23 For ratemaking purposes, the excess ADIT related to IRC protected book-tax differences,
24 primarily depreciation-related, are most often returned to customers using the Average
25 Rate Assumption Method ("ARAM") or an alternative approach known as the Reverse
26 South Georgia Approach ("RSGM"). Under ARAM, the excess ADIT cannot be reversed
27 any sooner than the book-tax difference establishing the ADIT in the first place reverses.
28 Under RSGM, the excess ADIT cannot be reversed any quicker than over the book life of
29 the related property. Excess ADIT related to non-protected book-tax differences can be
30 reversed over any period agreed to by the utility and its regulator.
31
32 The Company has been reversing excess ADIT using ARAM, including the excess ADIT
33 relating to the assets subject to this securitization.

1
2 **Q. What is the excess ADIT balance attributable to the Brown Unit's ADIT?**
3 A. In connection with the enactment of the TCJA, the ADIT related to the Brown Units were
4 remeasured. As of December 31, 2021, the remaining amount of excess ADIT on the
5 Brown Units was $20,501,980.
6
7 **Q. What is the effect of securitization on the excess ADIT for the assets subject to this**
8 **securitization?**
9 A. Once the Securitization Bonds are issued and the assets are reclassified to a regulatory
10 asset, they no longer are technically property, plant and equipment related. There
11 continues to be a book-tax difference on the securitized assets requiring ADIT, but upon
12 reclassification such ADIT may no longer be considered protected. Further, upon
13 reclassification to a regulatory asset, not only are the related ADIT possibly no longer
14 considered protected, but the excess ADIT may no longer be considered protected. As a
15 result, the excess ADIT may no longer have to be reversed to customers using ARAM.
16 However, as discussed below, the IRS has provided guidance on the continued reversal
17 of protected excess ADIT in situations in which assets are sold or retired in an
18 extraordinary retirement situation.
19
20 **Q. What is the Company proposing with respect to the excess ADIT related to the**
21 **securitized regulatory asset for the Brown Units 1 and 2?**
22 A. CEI South is proposing to amortize the excess ADIT relating to this regulatory asset on a
23 straight-line basis over the proposed 15-year amortization/recovery period. Under this
24 approach, annual amortization of the Brown Units' excess ADIT is $1,025,099. This is not
25 unlike the treatment FERC has discussed for excess ADIT related to protected property-
26 related book-tax differences existing on protected PP&E that are sold or retired. Upon
27 sale or disposal, the assets themselves are removed from the Company's books and
28 records, along with the associated ADIT.
29
30 In a Policy Statement (Docket No. PL19-2-000) issued in connection with the TCJA, the
31 FERC addressed this issue as follows:
32
33 In the Docket, the FERC proposed:

1 "14. With respect to ratemaking, for a public utility or natural gas
2 pipeline that continues to have an income tax allowance, any excess or
3 deficient ADIT associated with an asset must continue to be amortized
4 in rates even after the sale or retirement of that asset. **This excess or**
5 **deficient ADIT will continue to be refunded to or recovered from**
6 **ratepayers based on the schedule that was initially established.**
7 Similarly, for ratemaking purposes oil pipelines should keep records of
8 excess and deficient ADIT. (Emphasis added)."
9

10 After considering comments, FERC adopted this proposed treatment, concluding:

11 "40. The Commission has previously found that the sale or
12 retirement of an asset with an ADIT balance is usually deemed a
13 taxable event under IRS rules, and, as such, the ADIT balance is
14 extinguished as the deferred taxes then become payable to the
15 appropriate government authorities, and there is no longer an ADIT
16 balance to "return" to customers.
17

18 However, we believe that excess or deficient ADIT associated with
19 post-December 31, 2017, asset dispositions and retirements should be
20 treated differently for ratemaking purposes. For these assets, there are
21 two associated balances: (1) the ADIT balance based on the 21 percent
22 tax rate that will be owed to the IRS and (2) deficient ADIT or excess
23 ADIT balances resulting from the reduced tax liability that will not be
24 payable to the IRS upon the sale or retirement of the asset. While the
25 ADIT balance that needs to be settled with the IRS would be
26 extinguished following a sale, the deficient ADIT or excess ADIT
27 balances is more reflective of a regulatory liability or asset, and no
28 longer reflects deferred taxes that are still to be settled with the IRS and
29 need not be extinguished.
30

31 41. Additionally, we note that the rationale for continuing to amortize
32 deficient ADIT or excess ADIT balances in rates upon sales or
33 retirements of assets is substantively similar to the rationale for
34 amortizing excess ADIT in rates for assets that have not been sold or
35 retired. The difference is that for a sale or retirement, ADIT based on a
36 21 percent tax rate will be settled with the IRS immediately, while for an
37 asset that is not sold or retired, the ADIT will be settled with the IRS
38 over the remaining life of the asset as it depreciates. In other words,
39 the difference between the ADIT for assets that are sold or retired and
40 ADIT for assets that are not sold or retired is the timing of when
41 companies will settle the 21 percent of ADIT with the IRS. In both
42 scenarios, there is excess ADIT based on the 14 percent previously
43 collected from the customers that will no longer be payable to the IRS."
44

45 The Company's approach is to amortize the excess ADIT over 15 years using a RSGM-
46 type approach and not continue with ARAM (as it had been using prior to the
47 securitization). RSGM is consistent with the principle of reversing excess ADIT over the

1 amortization period of the underlying asset, in this case, the regulatory asset established
2 for the Brown Units 1 and 2.
3
4 **Q. Has the IRS provided guidance in situations where protected excess ADIT exist on**
5 **PP&E that is sold or retired?**
6 A. Yes. Current IRS regulations (Treas. Reg. Section 1.168(i)-3) permit the amortization of
7 protected excess and/or deficient ADIT even in the event that the underlying asset
8 associated with the ADIT has been sold or retired other than through an ordinary
9 retirement. These regulations require the return of the protected excess deferreds over
10 the same time period as if the assets were not sold or retired.
11
12 **Q. What happens if the excess ADIT associated with the securitized assets is returned**
13 **faster than over the 15-year period?**
14 **A.** Given that Treas. Reg. Section 1.168(i)-3 indicates that the excess ADIT should be
15 returned as if the underlying assets were not disposed of, I believe an acceleration of the
16 excess ADIT return could be a normalization violation. With the Company's proposal, the
17 amortization matches the recovery of the regulatory asset which is a proxy for the
18 underlying depreciable property. By accelerating the giveback beyond this, it would
19 appear the excess ADIT would be returned too quickly under the normalization rules.
20
21 **Q. What would be the consequences of a normalization violation on the excess ADIT?**
22 **A.** TCJA Section 13001(d)(4) provides that if the excess ADIT normalization rules are
23 violated, the taxpayer has to pay an additional tax for the difference between the
24 accelerated excess give back and what should have been given back under the rules. In
25 addition, the taxpayer loses the right to claim accelerated depreciation on its tax returns
26 going forward. These are significant penalties.
27
28 **Q. Your discussion of ADIT and excess ADIT is premised on the income tax rates in**
29 **effect when the book-tax differences originated (35%) and was remeasured when**
30 **the income tax rate was reduced (to 21%) resulting in a regulatory liability for the**
31 **excess ADIT. What happens in the event that the corporate income tax rate changes**
32 **during the reversal period?**

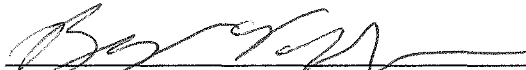
1 **A.** If the federal or state statutory income tax rate changes, following the same logic as
2 discussed above, the ADIT would need to be remeasured. If the rate is increased, the
3 ADIT itself would be increased from 21% to the new statutory rate (a credit) with an
4 offsetting Deficient (as opposed to Excess) Regulatory Asset. Alternatively, the offset
5 could reduce the remaining excess ADIT regulatory liability (a debit) recognizing that there
6 would now be "less excess". The entries would be the reverse in the event the tax rate is
7 further reduced. In the event of a tax rate change, the Company would need to adjust the
8 ADIT Credit described by Witness Rice.
9
10
11 **VII. SUMMARY**
12
13 **Q. Can you please summarize your direct testimony?**
14 A. Yes, CEI South is entering into a securitization transaction in which net securitization bond
15 proceeds will be received to reimburse Qualified Costs related to the Brown Units 1 and
16 2. For the receipt of such bond proceeds to be non-taxable, certain conditions must be
17 met to comply with Rev Proc 2005-62. The Company has met these conditions. As a
18 result, the net securitization bond proceeds will not be taxable and will be treated like any
19 other bond issuance. As a securitization surcharge is billed and collected from customers,
20 such revenues are taxable. As the Qualified Costs (now recorded as a regulatory asset)
21 are amortized on CEI South books (no longer deductible for tax as such assets have been
22 fully depreciable for tax), existing ADIT are reversed, with a separate ADIT established.
23 To comply with the IRS normalization rules, the excess ADIT related to the Brown Units 1
24 and 2 will continue to be reversed over the amortization period of the regulatory asset,
25 consistent with the FERC Policy statement on excess ADIT related to sold or retired
26 assets.
27
28 **Q. Does this conclude your direct testimony?**
29 A. Yes.

Cause No. 45722

VERIFICATION

I affirm under penalties for perjury that the foregoing representations are true to the best of my knowledge, information, and belief.

SOUTHERN INDIANA GAS AND ELECTRIC COMPANY D/B/A CENTERPOINT ENERGY INDIANA SOUTH



Benjamin Vallejo, Director Tax Planning & Strategy

5/10/2022

Date

CASE MIS No.: RP-115797-05

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also: Part 1, §§61, 451, 1001)

Rev. Proc. 2005-62

SECTION 1. PURPOSE

This revenue procedure sets forth the manner in which a public utility company may treat the issuance of a financing order by a State agency authorizing the recovery of certain specified costs incurred by the utility and the securitization of the rights created by that financing order.

SECTION 2. BACKGROUND

Revenue Procedure 2002-49, 2002-2 C.B. 172, provides a safe-harbor regarding the treatment of legislatively authorized transactions entered into by investor-owned electric utilities to recover transition costs resulting from the restructuring of the electric utility industry and the institution of a competitive marketplace. Some States enacted legislation to allow the recovery of these transition costs through a non-bypassable surcharge to customers within a utility's historic service area.

Utilities continue to operate in wholly or partially regulated environments and maintain exclusive distribution networks for customers in their historic service areas. Rates charged for these operations are determined by local authorities to allow for the recovery of costs and an appropriate return on capital. Some States have enacted legislation that allows utilities to recover certain specified costs through a surcharge based on consumption by customers within the utilities' historic service areas and also authorizes securitization of the surcharge. These statutes are unique to regulated utilities. Accordingly, the tax treatment allowed by this revenue procedure for these transactions is peculiar to this situation. See Revenue Procedure 2005-61, page **[INSERT PAGE NUMBER]**, this Bulletin, which adds certain related issues to areas in which rulings or determination letters will not be issued.

SECTION 3. CHANGES

The scope of Revenue Procedure 2002-49 was limited to transition costs that resulted from the deregulation of the generation operations of electric utility companies.

This revenue procedure expands the scope of Revenue Procedure 2002-49 to all public utility companies, and costs that are recoverable through a securitization mechanism are not limited to transition costs. Additionally, this revenue procedure eliminates certain requirements in section 4.04(3) of Revenue Procedure 2002-49 relating to level payments and now requires that payments be made on a quarterly or semiannual basis.

SECTION 4. SCOPE

This revenue procedure applies to investor owned public utility companies that, pursuant to specified cost recovery legislation, receive an irrevocable financing order from an appropriate State agency that determines the amount of certain specified costs the utility will be permitted to recover through qualifying securitization of an intangible property right created by the special legislation.

SECTION 5. DEFINITIONS

.01 PUBLIC UTILITY

For purposes of this revenue procedure, the terms “public utility” or “utility” refer to any investor owned utility company (electric or non-electric) that is subject to the regulatory authority of a State public utility commission or other appropriate State agency.

.02 SPECIFIED COST RECOVERY LEGISLATION

For purposes of this revenue procedure, specified cost recovery legislation is legislation that—

(1) Is enacted by a State to facilitate the recovery of certain specified costs incurred by a public utility company;

(2) Authorizes the utility to apply for, and authorizes the public utility commission or other appropriate State agency to issue, a financing order determining the amount of specified costs the utility will be allowed to recover;

(3) Provides that pursuant to the financing order, the utility acquires an intangible property right to charge, collect, and receive amounts necessary to provide for the full recovery of the specified costs determined to be recoverable, and assures that the charges are non-bypassable and will be paid by customers within the utility's historic service territory who receive utility goods or services through the utility's transmission and distribution system, even if those customers elect to purchase these goods or services from a third party;

(4) Guarantees that neither the State nor any of its agencies has the authority to rescind or amend the financing order, to revise the amount of specified costs, or in any way to reduce or impair the value of the intangible property right, except as may be contemplated by periodic adjustments authorized by the specified cost recovery legislation;

(5) Provides procedures assuring that the sale, assignment, or other transfer of the intangible property right from the utility to a financing entity that is wholly owned, directly or indirectly, by the utility will be perfected under State law as an absolute transfer of the utility's right, title, and interest in the property; and

(6) Authorizes the securitization of the intangible property right to recover the fixed amount of specified costs through the issuance of bonds, notes, other evidences of indebtedness, or certificates of participation or beneficial interest that are

issued pursuant to an indenture, contract, or other agreement of a utility or a financing entity that is wholly owned, directly or indirectly, by the utility.

.03 SPECIFIED COSTS

For purposes of this revenue procedure, specified costs are those costs identified by the State legislature as appropriate for recovery through the securitization mechanism of the specified cost recovery legislation.

.04 QUALIFYING SECURITIZATION

For purposes of this revenue procedure, a qualifying securitization is an issuance of any bonds, notes, other evidences of indebtedness, or certificates of participation or beneficial interests that—

(1) Is secured by the intangible property right to collect charges for the recovery of specified costs and such other assets, if any, of the financing entity that is wholly owned, directly or indirectly, by the utility;

(2) Is issued by a financing entity that is wholly owned, directly or indirectly, by the utility that is initially capitalized by the utility in such a way that equity interests in the financing entity are at least 0.5 percent of the aggregate principal amount of the non-equity instruments issued; and

(3) Provides for payments on a quarterly or semiannual basis.

SECTION 6. APPLICATION

.01 The utility will be treated as not recognizing gross income upon—

(1) The receipt of a financing order that creates an intangible property right in the amount of the specified costs that may be recovered through securitization;

Cause No. 45722

(2) The receipt of cash or other valuable consideration in exchange for the transfer of that property right to a financing entity that is wholly owned, directly or indirectly, by the utility; or

(3) The receipt of cash or other valuable consideration in exchange for securitized instruments issued by the financing entity that is wholly owned, directly or indirectly, by the utility.

.02 The securitized instruments described in Section 5.04 will be treated as obligations of the utility.

.03 The non-bypassable charges are gross income to the utility recognized under the utility's usual method of accounting.

SECTION 7. EFFECT ON OTHER DOCUMENTS

This document modifies, amplifies, and supersedes Rev. Proc. 2002-49.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE INTERNAL REVENUE BULLETIN.]**

SECTION 9. DRAFTING INFORMATION

The principal author of this revenue procedure is Thomas M. Preston of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure contact Mr. Preston at (202) 622-3970 (not a toll free call).