ILL. C. C. DOCKET NO. 12-0001
AIC Cross Exhibit No. 15
Witness Effron
Date 6-22-12 cB Reporter

AIC Cross Exhibit 15

~~NASUCA Fall~~ 2010 Tax and Accounting Panel

November 16, 2010

Ratemaking Issues from Uncertain Tax Positions and Other Significant Income Tax Issues of Importance in Recent Cases

Ralph C. Smith, CPA
Senior Regulatory Consultant, Larkin & Associates PLLC

Income Tax Issues

A. Issues with Uncertain Tax Positions

1. What are uncertain tax positions?

a. Per ASC-740-10-20, a "tax position" is:

> "A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term tax position also encompasses, but is not limited to:
>
> a. A decision not to file a tax return
> b. An allocation or a shift of income between jurisdictions
> c. The characterization of income or a decision to exclude reporting taxable income in a tax return
> d. A decision to classify a transaction, entity or other position in a tax return as tax exempt."

b. Also known as "FIN 48" for FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109."

c. Per ASC-740-10-25-6 an entity shall initially recognize the financial statements effects of a tax position when it is "more likely than not" based on the technical merits, that the position will be sustained upon examination. The "more likely than not" means the likelihood is more than 50 percent. The terms "examined" and "upon examination" include resolution of the related appeals or litigation processes. The "more likely than not" threshold is a positive assertion that an entity believes it is entitled to the economic benefits associated with a tax position. The level of evidence to support an entity's assessment of the technical merits of a tax position is a matter of judgment that depends on all available information.

d. Per ASC-740-25-8, if the "more likely than not" recognition threshold is not met in the period for which a tax position is taken, an entity shall recognize the benefit of the tax position in the interim period that meets any one of the following three conditions:

1) The more-likely-than-not recognition threshold is met by the reporting date.

2) The tax position is effectively settled through examination, negotiation or litigation.

3) The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

e. The IRS has also issued a requirement that corporations with assets over $100 million (beginning in 2010)[1] that issue audited financial statements and have reportable tax positions must report such positions on Schedule UTP which is filed with the corporation's tax return. A "tax position" taken on a return means a position that would result in an adjustment to a line on that tax return if the position is not sustained. If multiple positions impact a single line item, each tax position is a separately reportable tax position on the tax return. The IRS's draft instructions for Schedule UTP originally had requiring the corporation to report the rationale for the position taken as well as the maximum tax adjustment due to the position; however, after reviewing comments, those requirements were eliminated. In disclosing tax positions to the IRS on Schedule UTP a concise description of the tax position is required and "available on request" will not be considered to be an acceptable description. As 2010 is the first tax year for this disclosure requirement only tax positions taken after January 1, 2010 are required to be reported. Even if a reserve is recorded on financial statements issued in 2010 relating to a tax position, this position need not be disclosed if the position was taken prior to January 1, 2010 and has no impact on the 2010 return if the position is not sustained. However, if the reserve for the uncertain tax position involves continuous years, as is the case with a multi-year amortization of an expense, the position must be reported in each of the years affected by the reserve.

2. Financial and regulatory accounting for uncertain tax positions.

As described above, the financial accounting for uncertain tax positions would require a company with such positions to create a "reserve" relating to the uncertain amounts.

Some of the accounting we have seen so far has the utility recording significant debit-balance amounts in Account 190 that may be labeled as "FIN 48" or "Uncertain Tax Positions" for financial and regulatory accounting purposes. Account 190 is one of the Accumulated Deferred Income Tax accounts, and typically carries debit balances. If no ratemaking adjustment is made, the amounts in Account 190 may end up in rate base as

[1] The asset threshold for tax reporting on Schedule UTP is for corporations with $100 million assets for 2010. This asset threshold is reduced to $50 million beginning with 2012 tax years, and further reduced to $10 million beginning with 2014 tax years.

an increase to rate base. Also, the related liability amounts, which may have been recorded in a taxes payable account, such as Account 236, rather than in a credit-balance ADIT account, such as Accounts 282 or 283, could escape rate base recognition if not investigated. In most jurisdictions, the cost-free capital provided by ADIT recorded in Accounts 282 and 283 is recognized as such in the ratemaking process, either as a rate base deduction or as a source of cost-free capital in the capital structure. On the other hand, Account 236, Accrued Taxes, might not be recognized as a rate base offset in some jurisdictions.

FERC Accounting Guidance

The FERC has issued regulatory accounting guidance on uncertain taxes, which is attached to this outline. The FERC guidance provides as follows:

> Under existing regulatory accounting requirements, entities measure and recognize current and deferred tax liabilities (and assets) based on the positions taken or expected to be taken in a filed tax return and recognize uncertainties regarding those positions by recording a separate liability for the potential future payment of taxes when the criteria for recognition of a liability contained in FASB Statement No. 5, *Accounting for Contingencies*, are met, generally as part of the accrual for current payment of income tax. Where uncertainties exist with respect to tax positions involving temporary differences, the amounts recorded in the accounts established for accumulated deferred income taxes are based on the positions taken in the tax returns filed or expected to be filed. (Temporary difference as used here means a difference between the tax basis of an asset or liability as reflected or expected to be reflected in a tax return and its reported amount in the financial statements.) Recognition of a separate liability for any uncertainty related to temporary differences is therefore not necessary because the entity has already recorded a deferred tax liability for the item or would be entitled to record a deferred tax asset for the item if a separate liability for the uncertainty was recognized.
>
> This practice results in the accumulated deferred income tax accounts reflecting an accurate measurement of the cash available to the entity as a result of temporary differences. This is an important measurement objective of the FERC Uniform Systems of Accounts because accumulated deferred income tax balances, which are significant in amount for most Commission jurisdictional entities, reduce the base on which cost-based, rate-regulated entities are permitted to earn a return. **FIN 48, which does not permit a liability for uncertain tax positions related to temporary differences to be classified as a deferred tax liability, frustrates this important measurement objective.** Therefore, entities should continue to recognize deferred income taxes for Commission accounting and reporting purposes based on the difference between positions taken in tax returns filed or expected to be filed and amounts reported in the financial statements. Also, consistent with the direction provided in Docket No. AI93-5 regarding the implementation of FASB Statement No. 109, **public utilities and**

licensees, natural gas companies and centralized service companies should not remove from accumulated deferred income taxes and reclassify as a current liability the amount of deferred income taxes payable within 12 months of the balance sheet date.

3. Ratemaking and regulatory issues related to uncertain tax positions.

Utilities may not be utilizing the full amount of tax benefits claimed on tax returns as reductions to income tax expense or as rate base reductions related to increased amounts of Accumulated Deferred Income Taxes.

There may be other aspects of uncertain tax positions that appear in utility rate cases, such as debit-balance ADIT for "FIN 48" being added to rate base.

Areas where this has been a significant ratemaking issue have involved a number of different "tax positions."

The major change in tax accounting for repairs that has been adopted recently by many utilities seems to be one of the main areas. More details on that tax accounting method change are presented in a following section of this outline.

B. Major Change in Tax Accounting Method for Repairs

A major tax accounting change has arisen from proposed Treasury regulations on the deductibility of costs for repairs and replacements to tangible personal property. The United States Treasury Department has issued several proposed regulations relating to the capitalization of certain expenditures related to repairs and replacements of plant property. These proposed regulations would affect Section 1.263(a)-O through 1.263(a)3(h)(2) of the Treasury Regulations ("Proposed Regulations"). In general, under the current regulations, taxpayers are required to capitalize costs that are incurred to produce or acquire new property, or to add to the value of property, extend its useful life, or adapt it to a different use. Incidental repairs or maintenance costs are not required to be capitalized and would be expensed, therefore being deductible in the current tax year. Expenditures not required to be capitalized are generally deductible when incurred, as long as the other deductibility provisions of the Internal Revenue Code are met. The determination of which repair and replacement costs qualify for current deductibility and which must be capitalized has historically been an issue of debate between taxpayers and the IRS. In capital-intensive industries such as the utility industry, the determination of when to capitalize repair and replacement costs takes on a heightened importance.

Traditionally, in the utility industry, this determination has been centered on the concept of a "unit of property." A unit of property can be described as property, or a portion of property, that has been pre-defined as the threshold for capitalization. When a unit of property has been replaced, then the replacement cost would be capitalized for tax purposes. Costs incurred to repair or replace less than a unit of property, in general, would be deductible in the current year. For example, with respect to turbine blades in an electric generation unit, an entire row of blades may be (and typically is) the pre-defined unit of property. If all of the turbine blades, or an entire row of blades, were replaced, then the replacement costs would be capitalized for tax purposes. If certain blades, but less than an entire row, were replaced, then the costs would be deductible in the year the replacement costs were incurred. "Unit of property" concepts are not limited to tax application. In the utility industry, they sometimes are used to determine which costs are capitalized or expensed for regulatory purposes. Utilities, partially out of administrative convenience, have tended to use the same units of property for regulatory and tax purposes.

The Proposed Regulations would broaden the concept of unit of property by allowing components of property that are "functionally interdependent" to comprise a unit of property for tax purposes. So, in the example provided above, rather than a row of turbine blades serving as the definition of a "unit of property" for tax purposes, the unit of property might be considered to be the turbine itself, because all of the turbine's components (including its blades) are functionally interdependent. As a consequence, the replacement of the entire row of turbine blades, which would be capitalized for tax purposes under current practice, would instead not be capitalized under the Proposed Regulations, and the associated costs then would be deductible in the current tax year on the taxpayer's return. Because the Proposed Regulations serve to broaden the "unit of property" concept, application of them will necessarily result in less costs being capitalized and more costs qualifying for current deductibility for tax purposes than is generally available under the current rules.

In general terms, the Proposed Regulations are expected to provide for a significant increase in the deductibility of costs for utility companies and other capital-intensive industries. In addition, amounts that are capitalized under the current rules are subject to depreciation deductions. By deducting repair and replacement costs incurred in the current year, taxpayers will effectively reduce accumulated depreciation deductions in future years in an aggregate amount equal to the net amount of the current year benefit. In other words, the effect of the Proposed Regulations will be increased use of deductions for repair and replacement costs in the current year, and decreased use of depreciation deductions covering those same costs over the tax depreciation life of the repaired or replaced facilities (20 years). Thus, the effect is not to change the total tax liability, but only to change the timing of the tax liability. Accordingly, application of the Proposed Regulations merely accelerates the availability of tax deductions, and therefore produces a timing benefit only: at the end of the twenty-year period following the incurrence of a repair or replacement cost affected by the Proposed Regulations, the net tax impact will be zero. By taking advantage of the Proposed Regulations, however, the utility will receive accelerated tax deductions that will generate current year tax benefits. The availability of these current year tax benefits is passed along to the utility' customers through reductions to rate base as accumulated deferred income taxes that, in the ratemaking context, reduce the customer supplied capital needed to finance rate base.

On August 27, 2009, the IRS issued Revenue Procedure 2009-39, which provided for an automatic change process related to the change in the treatment of the kinds of costs covered by the Proposed Regulations. The significance of an automatic change process is that it allows taxpayers who comply with certain procedural rules to implement the change in accounting method on their federal income tax returns prior to receiving IRS approval. Under the process contemplated in Revenue Procedure 2009-39, while the IRS must ultimately approve the method and verify the underlying calculations though audit, the taxpayer may nevertheless implement the change in its compliance filing prior to this approval.

When a taxpayer makes an accounting method change, it must calculate the accumulated effect of the change as though the taxpayer had always applied the new method. If this calculated adjustment benefits the taxpayer, then the taxpayer may take the benefit of the adjustment in its first year of adopting the change. Section 481(a) of the Internal Revenue Code authorizes this "catch-up" adjustment. Catch-up adjustments are necessary to prevent omissions or duplications in transitioning to a new tax accounting method. Section 481(a) also ensures that taxpayers will be bound by all ramifications related to the new method prospectively.

There are many issues the IRS will need to resolve in finalizing the Proposed Regulations, in interpreting those regulations once they have been finalized, and in auditing many corporate income tax returns that incorporate various taxpayers' applications of the Proposed Regulations. Moreover, some definitions in the Proposed Regulations are not final, and the IRS will likely develop and refine interpretations and processes during its audits of taxpayers who have elected to implement the tax accounting change through the automatic process authorized in Revenue Procedure 2009-39. During this process, it is likely that, among other things, the IRS will scrutinize data used in the calculations, such as new unit of property determinations, accuracy of depreciation calculations, and characterizations of costs. To the extent the IRS disagrees with aspects of the utility's calculations, it may propose audit adjustments and modify taxable income as filed by the utility; to account for this possibility, the utility will record accounting reserves to reflect reasonable contingencies.

Ideally, the interest of the utility and its customers should be aligned. The rate process should encourage the utility make tax decisions that are prudent economically. Clearly, there is an economic cash flow benefit of accelerating tax deductions. Moreover, acceleration of tax deductions does not change the overall tax expense of the utility; it merely defers tax payment, and the regulatory process traditionally aligns the benefits of utilities and customers in such cases via the normalization of timing differences arising from the differences between book and tax depreciation methods. The regulation of utilities has recognized that a timing benefit is still recognized as a tax cost, and that the time value to the utility of that temporary benefit should be passed on to customers as a reduction in rate base for the associated ADIT. If the utility were to decline to make the election to apply the new tax accounting method, neither the utility nor their customers, through credits of ADIT, would ever receive the cash benefits on a time value of money basis that are available under the Proposed Regulations and Revenue Procedure 2009-39.

Jurisdictional rate base should be reduced for the value of the additional ADIT arising from application of the tax accounting change. This additional credit to rate base will reduce the utility's revenue requirement, both now and in the future, as the utility applies the new capitalization approach going forward. Since the new accounting method by its nature accelerates deductions, at all times there will be ADITs that serve to reduce rate base.

C. Other recent federal income tax developments of importance to utility regulation – 2010 bonus tax depreciation.

The Small Business Jobs Act signed into law by President Obama on September 27, 2010 reinstated the 50 percent bonus tax depreciation for 2010, retroactive to the beginning of the year. This impacts current cases using test years consisting of 2010 or beyond and can have a large impact, particularly if there is a high level of plant additions in 2010. The 2010 tax bonus depreciation is current law now and therefore constitutes a known and measurable change for any test years involving 2010 or later periods. There should be a substantial increase in the balance of Accumulated Deferred Income Taxes that offsets rate base, and thus a significant decrease to utility rate base.

D. Section 199 Domestic Production Deduction

The Section 199 deduction is typically seen for utilities that "manufacture" (rather than merely distribute) the utility service. As illustrative examples, the Section 199 deduction can have a significant impact on the income tax expense of water utilities that have and treat their own water supply and of electric utilities that own and utilize their own generation.

1. Participation in consolidated income tax return could reduce the benefit of the Section 199 deduction.

Section 199 of the Internal Revenue Code provides for a Manufacturing Deduction for Qualified Domestic Production. If the utility files a consolidated income tax return with a parent company and affiliates, its Section 199 deduction may have been reduced as a result of participation in the consolidated income tax return and the application of a tax sharing agreement with the consolidated group. It would generally not be appropriate to randomly quantify certain components of an income tax expense computation on a standalone basis and other components on a consolidated basis. Consequently, if a standalone tax basis is being used and the utility participates in a consolidated income tax return, inquires should be made to assure that the full amount of standalone deduction is being reflected for ratemaking purposes.

2. Increase in Applicable Percentage to 9 percent for years after 2009.

In 2009, the Section 199 deduction was calculated by applying an "applicable percentage" of 6 percent to Qualified Production Activities Income (QPAI). The applicable percentage for years after 2009 is 9 percent. If the test year or rate effective year extends beyond 2009, the use of the 9 percent could be a known and measurable adjustment.

E. Suggested Data Requests to Obtain Information Relevant to Recent Income Tax Issues

LA-1. Provide complete utility and parent company FIN 48 workpapers and supporting calculations for each year 2008, 2009 and 2010.

LA-2. Identify, quantify and explain in detail each uncertain tax position of the utility in each year, 2008, 2009 and 2010.

a. For each uncertain tax position, identify and explain the position, explain fully the basis for the uncertainty relating to it, explain over what time frame the uncertain is expected to be resolved, identify and provide all accounting entries related to the uncertain tax position in each year, identify and provide calculations for all interest and penalties for each uncertain tax position in each year.

LA-3. Identify, quantify and explain in detail each uncertain tax position of the utility and the parent company on the consolidated income tax returns and financial statements in each year, 2008, 2009 and 2010.

a. For each uncertain tax position, identify and explain the position, explain fully the basis for the uncertainty relating to it, explain over what time frame the uncertain is expected to be resolved, identify and provide all accounting entries related to the uncertain tax position in each year, identify and provide calculations.

b. For each parent company uncertain tax position, identify, quantify and explain fully how it affects (1) consolidated federal income taxes in each year; (2) recorded income tax expense and ADIT in each year; (3) costs and charges to the utility in each year.

LA-4. Has the utility or the parent company changed any tax accounting methods in any year, 2008, 2009 or 2010? If so, please identify each such change and quantify and explain the impact on income tax expense and on the utility's Accumulated Deferred Income Tax balances as of each date: 1/1/2008; 12/31/2008, 12/31/2009, 6/30/2010, 12/31/2010, [also for dates in FTY if applicable]? Show in detail how such impacts were determined.

a. Please provide all accounting entries and journal entry workpapers for 2008, 2009 and for 2010 to date related to any tax accounting method changes in any year since 2007.

LA-5. ADIT and SFAS 109.

a. Please identify, quantify and explain all impacts on expenses and rate base from SFAS 109.

b. When did the Company adopt SFAS 109 for financial reporting purposes?

c. Is this the first rate case in which utility has attempted to apply SFAS 109 for ratemaking purposes? If not, explain fully why not, and identify the other rate cases in which the utility attempted to use SFAS 109 for ratemaking purposes. If so, explain fully why.

LA-6. Provide detailed calculations of the Section 199 deduction in Excel and show in detail how it has affected the Company's income tax expense in the test year.

LA-7. Please provide the following information regarding deferred income taxes:

a. Calculation of all timing differences reflected in ADFIT; show book amount and tax amount; indicate when amounts were included in book and in tax returns;

b. Tax rate applied to each timing difference;

c. Calculation of actual DFIT;

d. If different, reconcile book amount per cost of service and book amount in DFIT calculation. Identify and quantify all reconciling items.

e. For each year 2007 through 2009 the gross and net additions to deferred taxes. Please breakdown such additions within each year by sub-account, providing the number and name for each account and sub-account. For each item by year, please reconcile the gross to net additions and explain how that reconciliation was derived.

f. For 2009 and 2010 (to date) please provide information requested in (e) above for each month, or quarter, corresponding with the frequency with which the Company updates its tax calculations for financial reporting purposes.

LA-8. Uncertain tax positions, rate base amounts.

a. Please state each amount for an uncertain tax position (per ASC 740, formerly FIN 48) that has been included in rate base, as additions to test year rate base.

b. Under the company's tax sharing/tax allocation agreement did the utility receive reimbursement for the amounts of deductions claimed on the tax return that relate to uncertain tax positions? If not, explain fully why not. Please identify, quantify and explain how the utility benefitted from each of the uncertain tax positions relating to deductions claimed or expected to be claimed on the tax returns. Please also identify when amounts received by the utility were received.

c. Please identify the specific provisions in the utility's tax sharing agreement that address uncertain tax positions.

d. Please provide complete (FIN 48) workpapers and analysis for all uncertain tax positions, for each period: 12/31/2007, 12/31/2008, 12/31/2009, 6/30/2010; and as projected for 12/31/2010; 12/31/2011 and 12/31/2012.

e. For each uncertain tax position, please identify and explain the specific circumstances that would result in it no longer being uncertain.

f. For each uncertain tax position for which an amount has been recorded in Account 190 or Account 236, please specify exactly and in detail why it is considered to be uncertain.

g. For each uncertain tax position for which an amount has been recorded in Account 190, please identify, quantify and explain the related amounts in FERC accounts (such as Accounts 236, 237 and 282) that have a credit balance.

LA-9. 2010 bonus tax depreciation.

a. Does the Company agree that the availability of 2010 bonus tax depreciation constitutes a known and measurable change for any test years involving 2010 or later periods? If not, explain fully why not.

b. Please provide a detailed listing by plant account of all plant and equipment added and/or projected to be added in 2010. Provide the listing in Excel.

c. Please identify, in the listing provided in response to part b, all plant and equipment having an MACRS recovery period of 20 years of less, and provide the MACRS recovery period for such property.

d. Does the Company intend to claim 2010 bonus tax depreciation? If not, explain fully why not.

e. Does the Company agree that the impact of utilizing the 2010 bonus tax depreciation is a substantial increase in the balance of Accumulated Deferred Income Taxes that offsets rate base, and thus a significant decrease to utility rate base? If not, explain fully why not.

f. Please provide calculations showing the impact of 2010 bonus tax depreciation on the test year rate base and include complete supporting calculations and Excel files.

Smart Grid Accounting Issues

Issues we have seen recently with respect to Smart Grid are primarily regulatory in nature, i.e., should recovery be made via base rates or by means of a tracker or surcharge/rider mechanism. Accounting related to tracker mechanisms typically involves the use of regulatory asset (for under-recorded balances) and regulatory liability (for over-recovered balances) accounts.

Accounting issues may involve the use of an accelerated amortization or depreciation period for the utility's existing investment in existing electronic or AMR meters that are being replaced with the Advance Metering Infrastructure (AMI).

Ratemaking Issues

Regulators and consumer representatives may be concerned about the use of special riders and other piecemeal ratemaking mechanisms that are being presented by utilities for recovery of Smart Grid related costs. The use of such riders contrasts with the traditional ways of recognizing plant additions in the context of utility general rate cases.

Concerns may also exist regarding the costs related to Smart Grid and AMI deployment that are to be recovered. Some utilities have continued to install electronic meters and Automated Meter Reading (AMR) enabled meters. If these relatively new meters would be prematurely retired, for proposed replacement by AMI, this may raise cost-benefit questions and issues concerning cost recovery. Utilities may request accelerated amortization of the net book value of electronic and AMR meters that are still on their books. In terms of depreciation rates applied to such existing meters, questions may arise as to their salvage value, if they are being retired and replaced within only a few years of initial installation.

Suggested Data Requests

LA-1. AMI meters.

a. Please provide a complete copy of the utility's cost-benefit analysis and business case for Smart Grid and AMI deployment.
b. Please provide all pages from the utility's last depreciation rate study that addressed the depreciation rates and related parameters for meters.
c. In developing depreciation rates, does the Company distinguish between AMI meters and any other types of meters? If not, explain fully why not. If so, please show in detail how the Company's existing (and proposed) depreciation rates were developed for each category of meters.
d. Please provide all information that was relied upon as the basis for the proposed AMI meter depreciation rate, including but not limited to, manufacturer expectations, engineering opinions and judgment which were utilized in a similar fashion for determining estimates to be used by other electric utilities for these assets.
e. Does the utility or its depreciation rate consultants have any information on how other electric utilities are depreciating their AMI meters? If not, explain fully why not. If so, please identify and provide such information.
f. Does the utility or its depreciation rate consultants have any information on how other electric utilities are depreciating their non-AMI meters? If not, explain fully why not. If so, please identify and provide such information.

g. To what degree is the Company's "business case" for AMI meter deployment dependent upon the Company's obtaining cost recovery of the net book value of existing meters? Identify, quantify and explain.
h. Is the Company aware of any other electric utilities in the U.S. or elsewhere that are, or are proposing to, recovery existing meter net book value in a similar manner to the utility's proposal? If not, explain fully why not. If so, please explain what the other electric utilities have proposed for the recovery of the value of existing meters that are being replaced because of the deployment of AMI meters.
i. For each type of non-AMI meter that the utility has, please identify the additions (quantity and cost) for such meters since 2006.
j. Please provide the Company's business case for installing the non-AMI meters in each year, 2005 through 2010, particularly in 2010 when the Company is requesting that they be retired on an accelerated basis.
k. Has the Company installed any non-AMI in any year, 2005 through 2010? If not, explain fully why not. If so, please identify the non-AMI meter installations by year, quantity and cost.

AIC Cross Exhibit ______

FEDERAL ENERGY REGULATORY COMMISSION
Office of Enforcement
Washington, D.C. 20426

In Reply Refer To:
OE
Docket No. AI07-2-000
May 25, 2007

TO ALL JURISDICTIONAL PUBLIC UTILITIES AND LICENSEES, NATURAL GAS COMPANIES, OIL PIPELINE COMPANIES AND CENTRALIZED SERVICE COMPANIES

Subject: Accounting and Financial Reporting for Uncertainty in Income Taxes

The Financial Accounting Standards Board (FASB) has issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, *Accounting for Income Taxes* (FIN 48 or the Interpretation). FIN 48, as amended by FASB Staff Position No. FIN 48-1,[1] clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109. The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or to be taken in a tax return. The Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Under FIN 48, an entity must evaluate all tax positions using a two-step process. The first step is recognition: The entity determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the entity should presume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The

---

[1] On May 2, 2007 FASB issued FASB Staff Position No. 48-1, Definition of *settlement* in FASB Interpretation No. 48, an amendment to FIN 48. FIN 48-1 clarifies how an entity should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits.

AIC Cross Exhibit ______

tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement.

The FASB states it issued FIN 48 because the absence of more definitive guidance in this area resulted in diversity in how entities recognize, derecognize, and measure potential tax benefits associated with tax positions. The FASB's stated objective in issuing the Interpretation is to increase comparability in financial reporting of income taxes.

Commission jurisdictional entities recognize income taxes in accordance with FASB Statement No. 109 for Commission accounting and reporting purposes. As previously noted, FIN 48 is an interpretation of FASB Statement No. 109. Although increasing the comparability in reporting of income taxes is generally desirable, it is also essential that the Commission and others have available to them financial information about jurisdictional entities' costs and revenues that is useful for the development and monitoring of rates charged for services provided. Certain aspects of FIN 48, if not implemented in accordance with the guidance contained herein, could reduce the usefulness of income tax data for ratemaking purposes and or otherwise be inconsistent with existing Commission accounting requirements. Therefore, Commission jurisdictional entities should implement FIN 48 for Commission accounting and reporting purposes, but in doing so should comply with the guidance set forth below.

The guidance is being provided to all jurisdictional entities to ensure proper and consistent implementation of FIN 48 for Commission financial reporting purposes beginning with the 2007 FERC Form Nos. 1, 1-F, 2, 2-A, 6, and 60 due to be filed in 2008. Earlier implementation is encouraged.

This guidance is for Commission financial accounting and reporting purposes only and is without prejudice to the ratemaking practice or treatment that should be afforded the items addressed herein. Neither FIN 48 nor the guidance contained in this letter for implementing the Interpretation for Commission financial accounting and reporting purposes relieves entities from the requirements of Section 154.305, Tax normalization [for interstate pipelines], or Section 35.24, Tax normalization for public utilities, of the Commission's regulations.

1. ACCOUNTING FOR AND REPORTING TAX POSITIONS

Background: FIN 48 applies to all tax positions accounted for in accordance with FASB Statement No. 109. The term *tax position* as used in FIN 48 refers to a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. As a result of applying the recognition and measurement provisions of this Interpretation, the amount of benefit recognized on the balance sheet may differ from the amount taken or expected to be taken in a tax return for the current year. These differences represent unrecognized tax benefits, which are the differences between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to the Interpretation. A liability is created (or the amount of a net operating loss carryforward or amount refundable is reduced) for an unrecognized tax benefit because it represents an entity's potential future obligation to the taxing authority for a tax position that was not recognized pursuant to the Interpretation. The Interpretation requires the liability to be reported as current to the extent the entity anticipates payment of cash within one year, or the operating cycle, if longer, and does not permit the liability for unrecognized tax benefits to be combined with deferred tax liabilities or assets.

Question 1: How should jurisdictional entities account for unrecognized tax benefits related to temporary differences[2] for Commission accounting and reporting purposes (Forms 1, 1-F, 2, 2-A, 3-Q, 6, 6-Q and 60)?

Response: Under existing Commission requirements, entities measure and recognize current and deferred tax liabilities (and assets) based on the positions taken or expected to be taken in a filed tax return and recognize uncertainties regarding those positions by recording a separate liability for the potential future payment of taxes when the criteria for recognition of a liability contained in FASB Statement No. 5, *Accounting for Contingencies*, are met, generally as part of the accrual for current payment of income tax. Where uncertainties exist with respect to tax positions involving temporary differences, the amounts recorded in the accounts established for accumulated deferred income taxes are based on the positions taken in the tax returns filed or expected to be filed. Recognition of a separate liability for any uncertainty related to temporary differences is therefore not necessary because the entity has already recorded a deferred tax liability for the item or would be entitled to record a deferred tax asset for the item if a separate liability for the uncertainty was recognized.

This practice results in the accumulated deferred income tax accounts reflecting an accurate measurement of the cash available to the entity as a result of temporary differences. This is an important measurement objective of the Commission's Uniform

---

[2] Temporary difference as used here means a difference between the tax basis of an asset or liability as reflected or expected to be reflected in a tax return and its reported amount in the financial statements.

Systems of Account[3] because accumulated deferred income tax balances, which are significant in amount for most Commission jurisdictional entities, reduce the base on which cost-based, rate-regulated entities are permitted to earn a return. FIN 48, which does not permit a liability for uncertain tax positions related to temporary differences to be classified as a deferred tax liability, frustrates this important measurement objective. Therefore, entities should continue to recognize deferred income taxes for Commission accounting and reporting purposes based on the difference between positions taken in tax returns filed or expected to be filed and amounts reported in the financial statements. Also, consistent with the direction provided in Docket No. AI93-5[4] regarding the implementation of FASB Statement No. 109, public utilities and licensees, natural gas companies and centralized service companies should not remove from accumulated deferred income taxes and reclassify as a current liability the amount of deferred income taxes payable within 12 months of the balance sheet date.

2. ACCOUNTING FOR AND REPORTING PENALTIES AND INTEREST

Background: When the tax law requires interest to be paid on an underpayment of income taxes, paragraph 15 of FIN 48 requires an entity to begin recognizing interest expense in the first period the interest would begin accruing according to the provision of the relevant tax laws. Also, if a tax position does not meet the minimum statutory threshold to avoid payment of penalties, paragraph 16 of FIN 48 requires an entity to recognize an expense for the amount of the statutory penalty in the period in which the enterprise claims or expects to claim the position in the tax return. Paragraph 19 of the Interpretation allows interest recognized in accordance with paragraph 15 to be classified

---

[3] *See* 18 C.F.R. Part 101, *Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act* (2006); 18 C.F.R. Part 201, *Uniform System of Accounts Prescribed for Natural Gas Companies Subject to the Provisions of the Natural Gas Act* (2006); 18 C.F.R. Part 352, *Uniform System of Accounts Prescribed for the Oil Pipeline Companies Subject to the Provisions of the Interstate Commerce Act* (2006); 18 C.F.R. § 366.22, *Accounts and records of service companies* (2006) and 18 C.F.R. Part 367, *Uniform System of Accounts for Centralized Service Companies Subject to the Provisions of the Public Utility Holding Company Act of 2005*, Order No. 684, issued October 19, 2006, *Financial Accounting, Reporting and Records Retention Requirements Under the Public Utility Holding Company Act of 2005*, FERC Stats. & Regs. ¶ 31,229 (2006).

[4] *Accounting for Income Taxes*, Letter Order to Public Utilities, Licensees and Natural Gas Companies, Docket No. AI93-5 (April 23, 1993) (unpublished letter order).

in the financial statements as either income taxes or interest based on the accounting policy election of the entity. Similarly, penalties recognized in accordance with paragraph 16 of the Interpretation may be classified in the financial statements as either income taxes or another expense classification, based on the accounting policy election of the entity.

Question: What FERC accounts should jurisdictional entities use to record and report interest expense and penalties applicable to underpayment of income taxes?

Response: The Commission's Uniform Systems of Account Prescribed for Public Utilities and Licensees, Natural Gas Companies and Centralized Service Companies require interest and penalties on tax deficiencies to be charged to Account 431, Interest Expense and Account 426.3, Penalties, respectively.[5] Therefore, public utilities and licensees, natural gas companies and centralized service companies should comply with these requirements for Commission accounting and reporting purposes. Classification of interest and penalties on tax deficiencies as income taxes is not permitted. Although not explicitly addressed in the Uniform System of Accounts Prescribed for Oil Pipeline Companies Subject to the Provisions of the Interstate Commerce Act, oil pipeline companies should charge interest expense and penalties on tax deficiencies to Account 660, Miscellaneous Income Charges, to similarly exclude such amounts from classification as income taxes for Commission accounting and reporting purposes.

3. ADJUSTMENTS TO RETAINED EARNINGS

Background: Paragraph 23 of FIN 48 requires the cumulative effect of applying the provisions of the Interpretation to be reported as an adjustment to the opening balance of retained earnings.

Question: How should FERC jurisdictional entities recognize any required adjustment to the opening balance of retained earnings? Is a separate filing requesting Commission approval of that accounting required?

Response: Public utilities and licensees, natural gas companies, oil pipeline companies and centralized service companies should use the accounts shown below to record any adjustment to the opening balance of retained earnings required in connection with

---

[5] *See* Account No. 236, Taxes Accrued and Account No. 426.3, Penalties. 18 C.F.R Parts 101, 201 and 367.

implementing FIN 48 for Commission accounting and reporting purposes. This guidance letter constitutes the required Commission approval for use of these accounts for this purpose and a separate filing with the Commission requesting such approval is not needed. Public utilities and licensees, natural gas companies and oil pipeline companies should report any amounts recorded in the accounts listed below on the lines designated for these accounts in the Statement of Retained Earnings contained in the FERC Form Nos. 1, 1-F, 2, 2-A, 3-Q, 6 and 6-Q.

Jurisdictional Entity	FERC Accounts
Public utilities and licensees (Major and Nonmajor)	Account 439, Adjustments to retained earnings
Natural gas companies	Account 439, Adjustments to retained earnings
Oil pipeline companies	Account 705, Prior period adjustments to beginning retained income account
Centralized service companies	
▯ Periods prior to January 1, 2008	Account 216, Unappropriated retained earnings
▯ January 1, 2008 and subsequent periods	Account 439, Adjustments to retained earnings

4. COST-OF-SERVICE TARIFFS/FORMULA RATE

Background: Jurisdictional entities may have cost-of-service tariffs or formula rates under which amounts billed each month will change based on amounts recorded pursuant to a Commission prescribed Uniform System of Accounts. Under the tariff or formula rate, only amounts recorded in certain specified accounts affect the monthly billings.

Question: May jurisdictional entities include in their monthly billings any amounts recognized or reclassified in connection with the implementation of FIN 48 for FERC reporting purposes?

Response: No. Adoption of the accounting guidance contained in this letter is for Commission accounting and reporting purposes only, and may not affect the measurement or periods in which amounts are included in jurisdictional entities' billing determinations without prior regulatory approval. If an entity's billing determinations are affected by the adoption of the guidance contained in this letter, the entity shall make a filing with the proper rate regulatory authorities before implementing the accounting change for billing purposes.

The Commission delegated authority to act on this matter to the Chief Accountant under 18 C.F.R. § 375.303 (2006). This guidance letter constitutes final agency action. Your company may file a request for rehearing with the Commission within 30 days of the date of this order under 18 C.F.R. § 385.713 (2006).

Anna V. Cochrane
Acting Chief Accountant