BEFORE THE NEW MEXICO PUBLIC REGULATION COMMISSION

IN THE MATTER OF THE APPLICATION OF PUBLIC SERVICE COMPANY OF NEW MEXICO FOR REVISION OF ITS RETAIL ELECTRIC RATES PURSUANT TO ADVICE NOTICE NO. 507	)	**Case No. 14-00332-UT**
PUBLIC SERVICE COMPANY OF NEW MEXICO,	)	
Applicant	)	

DIRECT TESTIMONY AND EXHIBITS

OF

MATTHEW F. HARLAND

DECEMBER 11, 2014

NMPRC CASE NO. 14-00332-UT
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WITNESS FOR
PUBLIC SERVICE COMPANY OF NEW MEXICO

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AFFIDAVIT

DIRECT TESTIMONY OF
MATTHEW F. HARLAND
NMPRC CASE NO. 14-00332-UT

I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

A. My name is Matthew F. Harland. I am the Director of Tax for Public Service Company of New Mexico ("PNM" or the "Company"). My address is 414 Silver Avenue, SW, Albuquerque, New Mexico 87102.

Q. PLEASE DESCRIBE YOUR RESPONSIBILITIES AS DIRECTOR OF TAX.

A. As Director of Tax I am responsible for managing the PNM tax department. This includes the preparation and filing of all tax returns, all tax accounting for both internal and external purposes, all tax planning, and managing all Federal and state tax audits. The only exception is payroll tax, which are calculated and filed by our payroll department.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN UTILITY REGULATION PROCEEDINGS?

A. Yes, I have previously testified before the New Mexico Public Regulation Commission ("NMPRC" or the "Commission") and the Public Utility Commission of Texas. A summary of the cases in which I have testified is included in PNM Exhibit MFH-1.

DIRECT TESTIMONY OF
MATTHEW F. HARLAND
NMPRC CASE NO. 14-00332-UT

Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?

A. My direct testimony covers the following areas:

- I am sponsoring Schedules H-9, H-10, H-11, H-12 and H-13, related to the tax computations and required under 17.9.530 NMAC.
- I discuss the stand-alone method of accounting for income taxes used in this case.
- I discuss the normalized income tax accounting methods used by PNM, as required by the Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic 740 ("ASC 740") (formerly FASB Statement of Financial Accounting Standards No. 109 ("SFAS 109").
- I discuss the income tax normalization requirements of the Internal Revenue Service ("IRS"), including those that relate to deferred tax assets resulting from Contributions In Aid of Construction ("CIAC").
- I discuss the IRS income tax normalization requirements that relate to deferred tax assets resulting from Net Operating Loss ("NOL") carryforwards.
- I discuss the additional IRS income tax normalization requirements specific to a future test period filing.
- I discuss the New Mexico corporate income tax rate reduction phase-in that occurs in 2014-2018.

- I discuss the Base Period to Test Period adjustments to Accumulated Deferred Income Taxes ("ADIT"), income tax expense, and current taxable income.

Q. HOW DOES YOUR TESTIMONY RELATE TO THE TESTIMONY PRESENTED BY OTHER COMPANY WITNESSES?

A. My testimony is directly related to the computation of both ADIT and income tax expense included in Schedule K-1, as presented by PNM witness Henry Monroy.

II. SUMMARY OF KEY CONCLUSIONS

Q. WHAT ARE THE KEY CONCLUSIONS OF YOUR TESTIMONY?

A. ADIT and income tax expense should be calculated on a fully normalized, stand-alone basis. All IRS normalization requirements, including, but not exclusively, those relating to accelerated tax depreciation, NOLs, CIAC, Investment Tax Credits ("ITC"), and future test periods should be strictly followed. This case as filed meets all of these requirements and fairly and accurately calculates both ADIT and income tax expense in the Base and Test Periods.

III. SCHEDULES H-9 THROUGH H-13

Q. PLEASE DESCRIBE THE PURPOSE OF SCHEDULES H-9 THROUGH H-13.

A. Schedule H-9 shows the calculation of Federal and state income tax expense for the Unadjusted and Adjusted Base Periods and the Test Period. The calculation of income tax expense in Schedule H-9 is used in the determination of revenue requirement for the Test Period, just as it has been in PNM's prior cases.

Schedule H-10 reconciles book income and current taxable income for the Unadjusted Base Period, the Adjusted Base Period and the Test Period. The calculation of current taxable income is purely informational, and is not included in the cost of service, as it does not affect total tax expense recoverable in rates.

Schedule H-11 relates to the effects of PNM's inclusion in the consolidated income tax return filings for PNM Resources & subsidiaries.

Schedule H-12 provides detail of the ADIT activity for the 12 months ended June 30, 2014 and ADIT balances for the Unadjusted and Adjusted Base Periods and the Test Period. The ADIT accounts included in rate base are those that relate to underlying assets or liabilities included in rate base. ADIT accounts that relate to assets and liabilities excluded from rate base are also excluded from rate base.

Schedule H-13 provides detail of the accumulated deferred ITC for the Unadjusted Base, Adjusted Base, and Test Periods.

Q. PLEASE DESCRIBE THE CALCULATION OF INCOME TAX EXPENSE ON SCHEDULE H-9.

A. Schedule H-9 calculates the income tax expense allowable in rates for the Unadjusted Base Period, the Adjusted Base Period, and the Test Period. The calculation begins with net pre-tax income as determined in the cost of service. Net pre-tax income is then adjusted for permanent book/tax differences. It is also adjusted for the reversal of temporary book/tax differences the benefit of which was previously flowed-through to customers. These are temporary differences that are treated as if they are permanent differences for ratemaking purposes. The adjusted net income is then multiplied by the statutory New Mexico and Federal tax rates to determine the preliminary tax expense. The preliminary tax expense is then reduced by the annual amortization of ITC, as shown on Schedule H-13, other allowable tax credits, and the reversal of excess deferred income taxes. With the exception of the reversal of prior flow-throughs, the tax expense on Schedule H-9 is calculated on a fully normalized basis, as that term is defined below. Therefore, it is correctly not adjusted for temporary book/tax differences. This is because temporary differences determine only the timing of the payment of taxes, and not the absolute amount of tax expense. These temporary differences are reflected, along with the permanent differences, in the calculation of current taxable income on Schedule H-10.

IV. STAND-ALONE TAX CALCULATION

Q. IS THE INCOME TAX EXPENSE IN THE COST OF SERVICE CACULATED ON A STAND-ALONE BASIS OR A CONSOLIDATED BASIS?

A. The income tax expense included in the cost of service is calculated on a stand-alone basis. No effects of the consolidated filing are included in the cost of service. This is consistent with prior PNM rate applications and prior Commission orders.

Q. SCHEDULE H-11 REQUIRES THAT THE COMPANY MAKE A REPRESENTATION REGARDING THE EFFECTS OF FILING CONSOLIDATED INCOME TAX RETURNS. WHAT ARE THOSE EFFECTS?

A. There are no effects on PNM resulting from the filing of consolidated income tax returns by PNM Resources. A pro-forma stand-alone income tax return is prepared for each of the affiliated companies, including PNM. These returns are, in turn, included in the PNM Resources consolidated income tax return, which is filed with the IRS. In 1984, PNM adopted an Inter-Company Tax Allocation

Policy that has been uniformly applied since that time with only minor changes. Under that policy, each company is treated on a stand-alone basis for purposes of computing its income tax expense. These stand-alone returns are then combined to create the consolidated return. This method did not change with the formation of PNM Resources, except that PNM Resources, rather than PNM, became the ultimate taxpayer liable to the IRS. PNM Resources (rather than PNM, as in the past) pays to the IRS the total current tax liability of the consolidated group. PNM and each of the other affiliated companies then reimburse PNM Resources for their respective stand-alone tax liabilities. In 2005, PNM Resources filed as a registered holding company under the Public Utility Holding Company Act of 1935 ("PUHCA"). As a result of this filing, slight changes to the Inter-Company Tax Allocation Policy were required. Slight changes were also made when the Inter-Company Tax Allocation Policy was redrafted in 2008, following the repeal of PUHCA. These changes never result in PNM being responsible to PNM Resources for tax expense in excess of its stand-alone share of the consolidated liability. Additionally, in some cases, a current tax expense or benefit occurs at a consolidated level and is allocated pro-rata to the business unit whose business activity resulted in the particular benefit or expense. No such items exist in the Test Period.

Q. WHY IS THE STAND-ALONE CALCULATION THE APPROPRIATE METHOD TO USE IN DETERMINING TAX EXPENSE?

A. As discussed above, the consolidated return is merely a summation of all the stand-alone tax returns for the companies included in the consolidated group. No tax benefits are created merely by filing a consolidated return. The stand-alone tax returns reflect the current tax expense resulting from the income and expenses related to the business activities of each separate company. As such, they correctly match the current tax expense of each entity with the income and expenses that created that tax liability. The stand-alone calculation prevents the cross-subsidization of one entity by another.

Q. DOES THE STAND-ALONE CALCULATION USED IN THE INTERCOMPANY TAX ALLOCATION POLICY AND THE COST OF SERVICE COMPLY WITH THE FINAL ORDER IN NMPRC CASE NO. 3137?

A. Yes, it does. The Final Order in NMPRC Case No. 3137 requires that:

> PNM's payment to the holding company for income tax shall be limited to PNM's share of the current income tax liability of the consolidated corporation.

The Intercompany Tax Allocation Policy ensures that PNM's payment is no more (or no less) than its stand-alone share of the consolidated tax liability. The stand-alone income tax calculation was used by PNM in its filings in Case No. 3137 for both the original cost of service and the illustrative cost of service filed in support of the stipulation in that case. It is the only method that ensures that PNM will always pay its share of tax expense, or be paid for its share of tax benefit, and no more. Any type of consolidated tax adjustment, which artificially shifts tax attributes from one entity to another, will, if consistently applied, cause PNM to pay either more or less than its share of the consolidated tax liability. This would result, by definition, in a cross-subsidization among entities.

Q. HAS THE STAND-ALONE CALCULATION BEEN EXPLICITLY APPROVED BY THE NMPRC?

A. Yes, it has. The issue of using a stand-alone versus a consolidated tax calculation was investigated in depth in NMPRC Case No. 07-00077-UT. The Recommended Decision, which was adopted by the Commission's Final Order in that case, states, on page 131:

> PNM and, especially, Staff have demonstrated that the stand alone method should be continued because it serves the public interest by being consistent with and promoting the accounting and regulatory principles of cost causation, the benefits/burden equation and prevention of cross subsidization.

V. ACCOUNTING FOR INCOME TAXES

Q. WHICH ACCOUNTING METHOD, NORMALIZATION OR FLOW-THROUGH, DOES PNM USE TO DETERMINE INCOME TAX EXPENSE AND ADIT IN THE COST OF SERVICE?

A. The normalization method. In NMPUC Case No. 2567, PNM proposed full tax normalization (for state as well as Federal tax purposes) for its electric operations for all new temporary differences. The normalization methodology was approved in that case and has been consistently used by PNM in every subsequent rate proceeding, including this one.

Q. PLEASE EXPLAIN NORMALIZATION ACCOUNTING.

A. Normalization accounting for income taxes calculates income tax expense on the pre-tax items of income and expense recorded for financial statement purposes or included in the cost of service for ratemaking purposes. The income tax expense is then adjusted for permanent differences between income recorded for financial reporting (book) purposes and income determined for income tax reporting (tax) purposes. Tax expense is then divided between the amount currently payable to the IRS, and the amount that must be paid in the future. This division between current and deferred tax expense is calculated based on temporary differences between book and taxable income. The tax expense incurred in the current year for which payment is deferred due to temporary book/tax differences is recorded on the balance sheet as a liability or asset, as the case may be.

The flow-through method, on the other hand, treats temporary differences not as a deferral of an incurred tax liability, but as a permanent reduction in the income tax expense for the period. This mischaracterization results in cross-subsidization of tax expense between customers in different periods, depending on when temporary differences originate and reverse.

Q. WHY IS NORMALIZATION SUPERIOR TO OTHER METHODS OF TAX ACCOUNTING?

A. Under normalization, tax expense is recognized in the same time period as the income or expense from which it is derived. In other words, tax expense is recorded when the liability to pay the tax is established, not when the taxes are actually paid. Then, an ADIT account is created for the portion of that tax that is not payable immediately, but is deferred and payable in a future year. In this way, normalization results in the proper allocation of tax expense between current and future customers while taking into account the time value of the savings resulting from deferred tax payments by including ADIT in rate base. For ratemaking purposes, the sum of all the ADIT accounts is generally a liability balance and therefore reduces rate base. This recognizes that the temporary cash savings resulting from the deferred tax payments represents a cost-free source of capital to the utility. The inclusion of the net ADIT liability ensures that customers receive the benefit of this cost free capital.

Q. CAN ADIT BE AN ADDITION TO RATE BASE, RATHER THAN A REDUCTION?

A. Yes, it can. Certain temporary book/tax differences increase, rather than decrease, taxable income. An example is interest expense on capital projects that is required to be capitalized and depreciated for tax purposes, but is deducted when incurred for book purposes. In this case, the cash tax payable actually exceeds the tax expense recorded for book purposes, but this excess will be returned to the Company over time. In such a case, an ADIT asset, rather than a liability, would be created. The theory and treatment is the same, however, for both ADIT assets and liabilities – their inclusion in rate base accounts for the difference between recoverable income tax expense and cash taxes paid.

Q. PLEASE EXPLAIN THE TERM "PERMANENT DIFFERENCE" AS IT RELATES TO THE RECORDING OF INCOME TAXES.

A. A permanent difference is a book/tax difference that will never reverse. Because of differences between the book (and ratemaking) accounting rules and the tax law, the taxability of some income or expense items will never be the same for book and tax purposes. These items affect the total income taxes paid over time, not just the timing of those payments.

An example of a permanent difference is 50% of meals and entertainment expenses. For book purposes, 100% of meals & entertainment expenses are generally deductible. For tax purposes, however, only 50% are considered deductible. The difference between the book deductibility and the tax deductibility is absolute and permanent, not merely related to the timing of the deduction. Therefore, tax expense must be increased by the tax on the non-deductible 50%.

Q. WHY ARE PERMANENT BOOK/TAX DIFFERENCES AND TEMPORARY BOOK/TAX DIFFERENCES NOT ACCOUNTED FOR IN THE SAME WAY?

A. Total tax expense recorded for book purposes over the life of the corporation must equal the total amount of tax remitted to the IRS over the life of the corporation. Because permanent differences never reverse over time, they affect the total tax paid, not just the timing of the payments. Therefore, book income tax expense must be adjusted for the change in tax expense created by these permanent differences. This is done on Schedule H-9 and on Schedule K-1. The accounting treatment for permanent differences is the same whether the normalization method or the flow-through method is used.

Temporary differences, on the other hand, are book/tax differences that reverse over time. Therefore, they affect only the timing of tax payments, and not the total income tax payable over time.

Q. PLEASE EXPLAIN THE TERM "TEMPORARY DIFFERENCE" AS IT IS USED ABOVE.

A. A temporary difference is a difference between book income and taxable income that arises in one tax year and reverses in later years. A temporary difference results in no change in total tax expense payable over the life of the underlying item. A temporary difference only affects the timing of the payment of such tax liability.

The use of accelerated depreciation for tax purposes is an example of an accounting method that gives rise to a temporary difference between book income and taxable income. Although depreciation on a given asset can only equal the asset's cost and can only be taken over the life of the asset, the timing of the depreciation deduction will differ when different depreciation methods are allowed for book and tax purposes. For example, assume that accelerated depreciation is used for tax purposes but the straight-line method is used for calculating book income. In this case, taxable income will be less than book income in the early years of the life of the asset, because the depreciation deduction for tax purposes is accelerated, or "front-end loaded." Correspondingly, taxable income will be greater than book income in later years, when the straight-line book method results in a higher depreciation deduction than that used for tax purposes. Over the life of the asset, the cumulative amounts deducted for depreciation will be the same for book and tax purposes, and the total income tax expense will be the same for both.

Q. PLEASE EXPLAIN WHY THE FLOW-THROUGH METHOD OF ACCOUNTING FOR TAXES SHOULD NOT BE USED.

A. The flow-through method of calculating income tax expense does not correctly match tax expense with the underlying pre-tax income and expense items in any one ratemaking period. It simply adjusts the total tax expense in any given year by the cash tax-savings or expense resulting from the temporary differences, both originating and reversing, in that year. In other words, taxable income for book and tax both reflect the current taxable income as reported on the tax return. In the accelerated tax depreciation example, use of the flow-through method will result in the current generation of customers being subsidized by a later generation.

Because temporary differences affect only the timing of tax payments, and not the total amount of the income tax liability, the flow through method also results in a mismatching of book income and the tax expense resulting therefrom. This is because certain pre-tax items are recognized for book purposes but their tax effect is not, and vice versa. The inclusion in the cost of service of tax expense based on current taxable income rather than on book income results in a mismatch of tax expense and recoverable expenses for ratemaking purposes as well. If the temporary differences result in a net reduction in current taxable income and, correspondingly, the tax expense included in the determination of rates, current customers would benefit unjustly at the expense of future customers who will have to pay higher tax expense when the temporary differences reverse. On the other hand, if a net increase in current taxable income results, it would be the current customers that would be adversely affected.

The flow-through method should not be used to calculate income tax expense because it does not correctly match tax expense with the underlying pre-tax income and expense items in any one ratemaking period, and results in a subsidization of costs between customers in different time periods.

VI. DEPRECIATION NORMALIZATION REQUIREMENTS

Q. MUST NORMALIZATION ACCOUNTING BE USED TO SET UTILITY RATES?

Yes. The Internal Revenue Code ("IRC" or the "Tax Code") § 168 mandates that, in determining rates using a cost of service methodology, regulated utilities must use the normalization method, and not the flow-through method, to calculate the tax expense related to depreciation-related temporary differences. Additionally, the temporary difference resulting from CIAC is specifically required to be normalized under IRS Notice 87-82, as discussed in IRS Private Letter Rulings[1] ("PLRs") 9035056 and 200933023. Similarly, NOLs are specifically required to be normalized, to the extent that they are created by accelerated tax depreciation. The normalization method correctly recognizes that temporary book/tax differences, by their nature, reverse over time, so that they affect only the timing of tax payments, not the total tax expense paid.

Q. WHAT IS THE PENALTY FOR VIOLATING THE IRS NORMALIZATION REQUIREMENT?

A. A normalization violation will result in the loss of the ability to use accelerated tax depreciation on all public utility property held by the utility. This would result in a substantial increase in rates, as customers would no longer enjoy the large rate base reduction resulting from depreciation-related ADIT liabilities.

[1] Although not strictly binding authority on taxpayers other than the one applying for the ruling, Private Letter Rulings issued by the IRS reflect their position on the issues discussed in the ruling. Such legal interpretations are important tools for tax practitioners, and are routinely relied on in applying the IRC and regulations to similar fact patterns. Taxpayers with similar facts rightly assume similar treatment in the absence of contrary authority.

Q. ARE UNREGULATED COMPANIES ALSO REQUIRED TO USE NORMALIZATION ACCOUNTING IN THEIR FINANCIAL STATEMENTS?

A. Yes, they are, but not by the IRS. Rather, under Generally Accepted Accounting Principles ("GAAP"), both regulated and unregulated companies are required to normalize all temporary book/tax differences. ASC 740 addresses the inter-period allocation of income tax expense. GAAP generally, and ASC 740 specifically, require the "normalization" of income taxes, and that deferred income taxes resulting from temporary book/tax differences be accounted for using the liability, or "ADIT", method for financial statement purposes. As required by GAAP, PNM adopted SFAS 96 (the predecessor to SFAS 109 and, ultimately, ASC 740) on January 1, 1990 and has consistently followed its normalization standards in all subsequent accounting periods.

VII. NOL ADIT NORMALIZATION REQUIREMENTS

Q. IN THE PREVIOUS SECTION, YOU MENTIONED THAT NOL CARRYFORWARD ADIT IS REQUIRED TO BE NORMALIZED IN CERTAIN CASES. IS PNM CURRENTLY IN A NET OPERATING LOSS CARRYFORWARD POSITION?

A. Yes, PNM is currently in a NOL carryforward position. Additionally, although PNM expects to utilize a large portion of that NOL carryforward before the Test

Period, it still expects to have some NOL carryforward remaining to be utilized in the Test Period.

Q. HAS PNM INCLUDED A NOL CARRYFORWARD ADIT ASSET IN RATE BASE IN THE BASE AND TEST PERIODS?

A. Yes, it has, consistent with GAAP and IRS normalization requirements.

Q. WHY IS PNM IN A NOL CARRYFORWARD SITUATION?

A. A NOL is created when tax deductions exceed taxable income. These deductions can arise from temporary book/tax differences such as accelerated tax depreciation. For capital intensive businesses such as utilities, the temporary bonus depreciation provisions of the IRC, in place since 2008, have often resulted in tax depreciation deductions so large that they created negative current taxable income. In 2010, 2011, and 2012 PNM incurred NOLs, because it generated deductions which exceeded its taxable income (on a consolidated basis, PNM Resources & subsidiaries incurred NOLs in 2010, 2012, and 2013).

When a company has negative current taxable income, it cannot realize the cash benefit of all of the deductions, because it cannot reduce its tax payments below zero. The NOLs must be deferred and carried forward to be used against taxable income in future periods, subject to certain limitations. Only then will the taxpayer receive the cash tax benefit of these NOLs.

When carried forward, the NOL is a temporary book/tax difference for which an ADIT asset must be recorded. The sum of (i) the ADIT liability created by the bonus depreciation and (ii) the ADIT asset created by the NOL carryforward represents the cash tax benefits that were <u>actually received</u> by the company.

Q. IS IT SOUND REGULATORY AND ACCOUNTING PRACTICE TO INCLUDE THE NOL CARRYFORWARD ADIT IN RATE BASE?

A. Yes, it is. This treatment assures that PNM and its customers receive the benefit of the actual deferred tax payments, no more and no less. Including only the ADIT liability from accelerated tax depreciation, including bonus depreciation, and not also the offsetting NOL carryforward ADIT asset, would treat the Company as if it had realized the entire benefit of the bonus depreciation in the years in which it was earned. In reality, a substantial portion of that benefit is required to be deferred, only to be realized in future years. The reason that ADIT liabilities are included as a reduction to rate base is to compensate customers for the cash benefit, or cost-free capital, that the utility has received due to the temporary acceleration of certain expenses for tax purposes. By not including the NOL carryforward ADIT asset as an addition to rate base, this benefit would be greatly overstated.

In *Kern River Gas Transmission Company,* FERC Docket No. RP07-274-000, a situation almost identical to PNM's was litigated. In that case, the FERC addressed both ADIT assets generally, and NOL carryforward ADIT assets specifically. It concluded:

> 229. There is a second type of timing [difference] that can have the opposite effect. It is possible that some accounting entries will decrease expenses or increase income for IRS purposes faster than would be the case for accounting purposes. In this case the cash flow from the tax allowance embedded in the regulated entity's rates is less than the income tax payments that are generated by the higher income. When the regulated entity pays for an expense earlier than would be under the Commission's regulatory accounting system, it is in essence committing more funds to the business. The difference is therefore capitalized and added to the rate base. The difference in the timing that results is capitalized and added to the rate base to allow a somewhat higher return on the additional funds that have need committed to the enterprise. As the accounting entries for these expenses are entered (usually allowance of funds used during construction), the difference in timing is reversed, the short term addition to the rate base decreases, and return drops. This timing difference is reflected as an ADIT debit, or regulatory asset, in Account No. 190.
>
> 230. In the instant case the NOL was properly included in Account No. 190. The large depreciation deduction for the "bonus" depreciation was properly reflected as a credit in Account No. 282 and served to reduce rate base to reflect the difference in timing previously described. However, the impact of this deduction was so great that it exceeded the taxable cash that would have been generated under the

> straight line regulatory method. Thus, Kern River was not able to use the full extent of the deduction in the first year it was available. However, as discussed, the full accelerated depreciation amount is included in the credit ADIT in Account No. 282. Without a corresponding debit in Account Mo. 190, Kern River's rate base would be reduced even through [sic] it did not achieve the tax savings, and additional cash flow, that a credit entry in Account No. 282 is intended to offset. Therefore, the NOL is carried forward as a regulatory asset in future years and is reduced as the tax savings actually accrue to Kern River. <u>Offsetting the NOL against the total ADIT reduction in the first year assures that the rate base is reduced only as the company actually obtains the additional cash flows, and hence the return, that the ADIT tax methodology captures for the ratepayer (emphasis added).</u>

Although this FERC decision is not binding on other Commissions, it does provide an excellent analysis of the issue.

Q. IS THE INCLUSION IN RATE BASE OF THE NOL CARRYFORWARD ADIT REQUIRED BY THE IRS?

A. Yes, it is. Treasury Regulation Section § 1.167(l)-1(h)(1)(iii), specifically addresses this situation:

> If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (l) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (l) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

PLR 8818040, and more recently, PLRs 201436037, 201436038, and 201438003 clarify that a tax calculation with and without accelerated depreciation is utilized to determine the amount of the NOL carryforward ADIT required to be normalized. To the extent that accelerated depreciation creates a NOL carryforward, the NOL carryforward ADIT asset must be included in rate base. Excluding this NOL carryforward ADIT asset would constitute a normalization violation.

Q. PLEASE DISCUSS THE THREE RECENT PLRS MENTIONED ABOVE.

A. These three PLRs are important because they deal with facts almost identical to PNM's. Before the introduction of bonus tax depreciation, very few regulated utilities incurred NOLs on a stand-alone basis. This accounts for the dearth of recent PLRs on the issue of NOL carryforward ADIT normalization. With the enactment of bonus depreciation in 2008, and its continued extension through 2013, NOLs have become much more common for utilities in recent years. Many commissions are dealing for the first time with the question of whether to include NOL carryforward ADIT assets in rate base. As a result of their commissions' final orders, several utilities are seeking PLRs regarding NOL carryforward ADIT normalization. All three of the referenced 2014 PLRs relate to whether NOL carryforward ADIT assets are required to be included in rate base, and how to calculate the required includible amount.

Q. WHAT CONCLUSIONS DO THESE PLRS REACH?

A. These three PLRs confirm that in order to avoid a normalization violation, NOL carryforward ADIT assets must be included in rate base and that the correct method for determining the amount that must be included is a with-and-without approach. In other words, the hypothetical taxable income of the utility is calculated with and without accelerated tax depreciation. The change in the taxable loss (NOL) that results is the amount for which NOL carryforward ADIT must be included in rate base to prevent a normalization violation. If the change exceeds the NOL, the entire NOL carryforward ADIT must be included in rate base. All three PLRs contain essentially identical language, as follows:

> Because the ADIT account [*Account 282*], the reserve account for deferred taxes, reduces rate base, <u>it is clear that the portion of an NOLC [*Account* 190] that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT)</u>... The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers (underlines and [*FERC Account references*] added for clarity).

Q. WHAT IS THE PENALTY FOR VIOLATING THE IRS NORMALIZATION REQUIREMENT REGARDING NOLS?

A. Because the NOL normalization rules are a subset of the depreciation normalization rules, a violation of the NOL normalization requirement would result in the loss of the ability to use accelerated tax depreciation on all public utility property held by the utility.

VIII. FUTURE TEST PERIOD NORMALIZATION REQUIREMENTS

Q. ARE THERE ADDITIONAL IRS NORMALIZATION REQUIREMENTS THAT RELATE SPECIFICALLY TO FUTURE TEST PERIOD FILINGS?

A. Yes, there are. Treasury Regulations issued under IRC § 167 govern the determination of the amount of ADIT allowable as a rate base reduction in a future test year. Specifically, Treas. Reg. § 1.167(l)-1 mandates special "proration rules" when a future test period is used in determining rates, and the newly determined rates are expected to be in effect for all or a portion of that test period.

Q. DO THESE PRORATION RULES APPLY TO ALL ADIT BALANCES INCLUDED IN RATE BASE?

A. No, they do not. The proration rules only apply to depreciation-related ADIT. Other ADIT balances are not required to be pro-rated.

Q. PLEASE DISCUSS THESE FUTURE TEST PERIOD NORMALIZATION REQUIREMENTS.

A. Under Treas. Reg. § 1.167(l)-1, when a future test period is used to set rates and the newly determined rates are expected to be in effect for all or a portion of that test period, the utility plant ADIT additions in the portion of the test period in which the new rates are expected to be in effect must be pro-rated.

In this filing, the future period is the year ending December 31, 2016. Collection of the new rates is expected start on January 1, 2016. Therefore, the new rates are expected to be in place for the entire Test Period. Under the proration rules all utility plant ADIT additions are pro-rated, using a ratio in which the numerator is the number of days remaining in the Test Period, and the denominator is the number of days during which the new rates are expected to be in effect in the Test Period (365). Because PNM closes its books on a monthly basis, the proration is also done on a monthly basis. As a result, January 2016 utility plant ADIT additions are pro-rated using a ratio of 335/365, February additions are pro-rated by 304/365, and so on, until December 2016 ADIT additions are pro-rated by 1/365.

Q. ARE SIMILAR PRORATION RULES APPLICABLE TO THE CALCULATION OF INCOME TAX EXPENSE IN A FUTURE TEST PERIOD?

A. No. Income tax expense in a future test period is calculated in the same manner as that calculated for a historic test period.

IX. BASE PERIOD ADJUSTMENTS

Q. WERE ADJUSTMENTS MADE TO ADIT IN THE BASE PERIOD?

A. Yes. ADIT adjustments have been made in the Base Period where necessary to track adjustments to underlying rate base items. These include:

- Model-Driven Calculations – ADIT balances that relate to regulatory assets and liabilities and other rate base items are trued-up to equal the balance of the underlying account multiplied by the combined Federal and state tax rate of 39.59%. These adjustments are shown on Schedule H-12, page 1, column F.
- ADIT balances are adjusted to the average balance for the Base Period. The averaging adjustments are shown on Schedule H-12, page 1, column H, referenced "a".
- ADIT balances for General Plant and Net Operating Loss carryforwards are adjusted to reflect the corporate allocation adjustment to G&I Plant. These adjustments are shown on Schedule H-12, page 1, column H, referenced "c".
- ADIT balances on certain regulatory assets and liabilities are adjusted to reflect changes to the underlying assets and liabilities shown on PNM Exhibit HEM-3, W/P RA-1. The ADIT changes are shown on Schedule H-12, page 1, column H, referenced "r".

- ADIT balances on certain other rate base items are adjusted to reflect changes to the underlying assets and liabilities shown on PNM Exhibit HEM-3, W/P ORB-1. The ADIT changes are shown on Schedule H-12, page 1, column H, referenced "o".

Q. WERE ADJUSTMENTS MADE TO INCOME TAX EXPENSE IN THE BASE PERIOD?

A. Yes. Several items in the income tax expense calculation were trued-up to full-year amounts. This is necessary because the effective tax rate methodology for interim (quarterly) reporting required by GAAP does not recognize permanent differences ratably over the year. Therefore, a mismatch between straight-line amortization and the amount included in the effective rate may occur in the interim periods. The following amortizations were trued-up to a full year of amortization:

- Eastern Interconnect Project;
- Palo Verde Units 1 & 2 Gain Amortization Flow Through;
- Palo Verde Units 1 & 2 Prudence Audit Flow Through;
- Federal Grant Amortization – Renewables;
- Federal Grant Basis Adjustment – Renewables;
- Amortization of EIP Prepaid Tax Reversal;
- ARAM Deferred Tax Reversal; and
- All Other ITC Amortization.

Additionally, the permanent difference for non-deductible meals was trued-up to accurately reflect 50% of the meals expense included in the Base Period cost of service.

X. TEST PERIOD ADJUSTMENTS

Q. WERE ADJUSTMENTS MADE TO ADIT IN THE TEST PERIOD?

A. Yes. ADIT for the Test Period has been adjusted for the following:

- The IRS-required proration of depreciation related ADIT discussed in Section VII of this testimony. These adjustments are shown on Schedule H-12, page 2, column D.
- ADIT balances are adjusted to the average balance for the Test Period. The averaging adjustments are shown on Schedule H-12, page 2, column E.
- ADIT balances for General Plant and Net Operating Loss carryforwards are adjusted to reflect the corporate allocation adjustment to G&I Plant. These adjustments are shown on Schedule H-12, page 2, column F.
- The ADIT balance for pension has been adjusted to reflect the effect of the Test Period adjustment to the prepaid pension asset. This adjustment is shown on Schedule H-12, page 2, column F.

Q. WERE ADJUSTMENTS MADE TO INCOME TAX EXPENSE IN THE TEST PERIOD?

A. Yes. The income tax expense calculation has been adjusted for the following:

- A permanent deduction for the Domestic Production Activity Deduction ("DPAD") has been added in the Test Period. This deduction was not included in the Base Period because it is limited by taxable income. Therefore, PNM's Base Period NOL carryforward position eliminates the DPAD in that period.
- The permanent book/tax difference for non-deductible meals was trued-up to accurately reflect 50% of the meals expense included in the Test Period cost of service.
- The permanent differences for AFUDC equity have been eliminated because no AFUDC Equity is accrued in the Test Period.
- The permanent differences for the EIP Gain Amortization and the PVNGS Prudency Audit Decision have been eliminated because those items have been fully amortized prior to the Test Period.
- Depreciation flow-throughs have been recalculated for the Test Period using updated book depreciation rates.
- The Gain/Loss flow-through has been eliminated in the Test Period.
- ITC amortization has been recalculated using the current estimated useful lives for the Palo Verde and San Juan generating stations.

- The R & D Credit has been eliminated in the Test Period because it expired as of December 31, 2013.
- The Average Rate Assumption Method ("ARAM") reversal of excess deferred taxes has been recalculated using the current estimated useful life for the San Juan generating station.

The above changes are shown on Schedules H-9 and H-10.

XI. NEW MEXICO INCOME TAX RATE CHANGE

Q. PLEASE DISCUSS THE RECENT NEW MEXICO INCOME TAX RATE CHANGE.

A. In 2013, New Mexico House Bill 641 was signed into law. Among other things, the bill included a prospective reduction in the New Mexico corporate income tax rate. The rate reduction phases in over five years beginning in 2014. The phase in and its effect on the combined Federal and state income tax rate is as follows:

Rate	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Federal	35.00%	35.00%	35.00%	35.00%	35.00%	35.00%
New Mexico	7.60%	7.30%	6.90%	6.60%	6.20%	5.90%
Combined	39.59%	39.42%	39.20%	39.02%	38.79%	38.62%

Q. HOW DOES THE RATE CHANGE AFFECT THE COST OF SERVICE CALCULATIONS?

A. The state income tax rate used in calculating income tax expense is reduced from the historic 7.60% to 6.60% in the Test Period, thereby reducing the amount of income tax expense included in the cost of service. Additionally, incremental ADIT in the cost of service is calculated at the tax rate in effect when the increment occurs (39.20% in 2015, 39.02% in 2016).

Q. WILL THE RATE CHANGE HAVE ANY OTHER EFFECTS?

A. Yes, the rate reduction will result in what are known as excess deferred state income taxes.

Q. PLEASE EXPLAIN THE CONCEPT OF EXCESS DEFERRED INCOME TAXES.

A. When deferred taxes are recorded and included in income tax expense in the cost of service, they are generally calculated at the rate in effect when the deferred tax was created. For years, this rate has been 39.59% for PNM. These deferred taxes create ADIT because they are not paid in the year the expense is recorded but in a later year. As a result of the rate reduction, those deferred taxes will be paid at a lower rate than that at which they were accrued. The difference between the amount accrued and the amount expected to be paid at the lower rate is called excess deferred income tax.

Q. IS THE AMOUNT OF THE EXCESS DEFERRED INCOME TAXES THAT RESULTS FROM THE NEW MEXICO TAX RATE CHANGE KNOWN AT THIS TIME?

A. No, it is not. The amount of the excess deferred income taxes will not be known until the rate phase-in of the tax rate reduction is complete in 2018. This is because it is the ADIT balances at that time that will ultimately be paid at the new fully phased-in rate and those balances are not now known.

Q. HOW DOES PNM PROPOSE TO TREAT THE EXCESS DEFERRED INCOME TAXES?

A. Because the amount of the excess deferred state income taxes is not yet known, PNM proposes to defer the amount and record a regulatory liability. This regulatory liability would be fixed in amount in 2018 and returned to customers over some time period which reasonably reflects the period over which the actual deferred benefit of the lower rate will be realized by PNM. This period would be determined in PNM's first rate case subsequent to the full phase-in of the tax rate reduction in 2018. PNM proposes that ARAM, or a reasonable facsimile, be used to determine the timing of the return to customers. This is the same mechanism that the IRS required for the excess deferred income taxes created by the Federal income tax rate reduction in the Tax Reform Act of 1986. This mechanism protects customers, because the ADIT offset to rate base is not reduced by the effect of the rate change until the excess deferred income taxes are returned to customers through a reduction to income tax expense. Additionally, it protects the Company by matching the timing of the return of the excess deferred income taxes to customers with the timing of the actual cash benefit received by PNM as the ADIT reverses at the future lower rate.

XII. CONCLUSIONS

Q. DO YOU HAVE ANY CONCLUDING OBSERVATIONS?

A. Yes, I do.

- The ADIT and income tax expense included in the Base Period and Test Period cost of service are fair and accurate based on the underlying rate base and recoverable expenses included in the cost of service.
- The calculations of tax expense and ADIT comply with all IRS normalization requirements, including those related to accelerated tax depreciation, NOLs, and CIAC. The Test Period adjustments to ITC amortization and excess deferred income tax amortization ensure compliance with the normalization requirements for those items. The Test Period proration of certain plant-related incremental ADIT ensures compliance with the normalization requirements for future test periods.
- The income tax calculations are all done on a fully normalized basis, consistent with Commission precedent and past PNM filings.

- The income tax calculations are all done on a stand-alone company basis, consistent with the Commission's decision in NMPRC Case No. 07-00077-UT and past PNM filings.
- Finally, the amount of the excess deferred income taxes related to the phased-in reduction in the New Mexico state income tax rate should be determined in PNM's first rate case after 2018 when the tax rate reduction will be fully phased-in, and should be returned to customers over a period determined using ARAM or some reasonable facsimile thereof. The period should reasonably reflect the period over which the benefit will be realized by PNM through the reversal of the affected ADIT.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

CGC#518972

Resume of Mathew F. Harland

PNM Exhibit MFH-1

Is contained in the following 3 pages.

MATTHEW F. HARLAND, CPA

EDUCATIONAL AND PROFESSIONAL SUMMARY

Employment:

PNM Resources, Inc. and affiliated companies:
Director of Taxation, 2010-Present
Director of Income Tax, 2008-2010
Senior Manager, Corporate Tax Projects, 2005-2008
Senior Manager, Corporate Tax Projects, 2002-2005
Senior Manager, Corporate Tax Projects, 2000-2002
Manager of Tax Planning, 1999-2000
Senior Tax Analyst, 1991-1999

KPMG Peat Marwick:
Income Tax Senior Accountant, 1989-1991
Income Tax Staff Accountant, 1987-1989

Education:

Master of Accountancy:
New Mexico State University, Las Cruces, NM, 1986

Bachelor of Arts in Economics:
Pomona College, Claremont, CA, 1983

Continuing Professional Education:
Tax and Accounting CPE as required by the New Mexico State Board of Public Accountancy

Certification:

Certified Public Accountant:
New Mexico, 1989-Present

Affiliations:

American Institute of CPAs: Tax Section member
Edison Electric Institute: Taxation Committee Chair & past Vice-Chair
Tax Analysis & Research Subcommittee member
Energy Tax Council: Member
Tax Executives Institute: Member
New Mexico Tax Research Institute: Director
Association of Electric Companies of Texas: Tax Committee member

Testimony in Regulatory Proceedings:

Nature of Proceeding	Regulatory Body	Docket Number
In the Matter of the Application of Public Service Company of New Mexico for Approval of Renewable Energy Rider No. 36 Pursuant to Advice Notice No. 439 and for Variances from Certain Filing Requirements.	NMPRC	12-00007-UT
In the Matter of an Investigation into Public Service Company of New Mexico's Amendments to its Line Extension Policy made by its Advice Notice Nos. 428, 429, 50 and 51.	NMPRC	11-00430-UT
In the Matter of the Application of Public Service Company of New Mexico for Revision of its Retail Electric Rates pursuant to Advice Notice No.s 397 and 32 (former TNMP Services).	NMPRC	10-00086-UT
In the Matter of the Transfer of Public Service Company of New Mexico's Unamortized Accumulated Deferred Investment Tax Credit of its Gas Utility. (Private Letter Ruling)	NMPRC	08-00377-UT
In the Matter of the Application of Public Service Company of New Mexico for Revision of its Retail Electric Rates pursuant to Advice Notice No. 352.	NMPRC	08-00273-UT
In the Matter of the Applications of Public Service Company of New Mexico and New Mexico Gas Company, Inc. for the Abandonment, Purchase and Sale of the Gas Utility Assets and Services and for Related Authorizations and Variances.	NMPRC	08-00078-UT
In the Matter of the Application of Public Service Company of New Mexico for Revision of its Retail Electric Rates pursuant to Advice Notice No. 334.	NMPRC	07-00077-UT
In the Matter of the Petition of Public Service Company of New Mexico for a Revision to its Rates, Rules, and Charges pursuant to Advice Notice No.s 755 and 756.	NMPRC	06-00210-UT
In the Matter of the Petition of Public Service Company of New Mexico for a Revision to its Rates, Rules, and Charges	NMPRC	03-00017-UT

pursuant to Advice Notice No.s 721 and 722.

Application of Texas New Mexico Power Company for Authority to Change Rates.	PUCT	38480
Application of Texas New-Mexico Power Company for Authority to Change Rates.	PUCT	36025
Application of Texas New-Mexico Power Company to Adjust Carrying Charges pursuant to P.U.C. Subst. R. 25.263.	PUCT	33106
Application of Texas-New Mexico Power Company to Establish a Competitive Transition Charge pursuant to P.U.C. Subst. R. 25.263(n).	PUCT	31994

BEFORE THE NEW MEXICO PUBLIC REGULATION COMMISSION

IN THE MATTER OF THE APPLICATION OF PUBLIC SERVICE COMPANY OF NEW MEXICO FOR REVISION OF ITS RETAIL ELECTRIC RATES PURSUANT TO ADVICE NOTICE NO. 507	)	**Case No. 14-00332-UT**
PUBLIC SERVICE COMPANY OF NEW MEXICO, Applicant.	)	

AFFIDAVIT

STATE OF NEW MEXICO)
) ss
COUNTY OF BERNALILLO)

MATTHEW F. HARLAND, Director of Income Tax for PNM Resources, Inc. and its subsidiaries including Public Service Company of New Mexico, upon being duly sworn according to law, under oath, deposes and states: I have read the foregoing **Direct Testimony and Exhibits of Matthew F. Harland** and it is true and accurate based on my own personal knowledge and belief.

SIGNED this 5th day of December, 2014.

____
MATTHEW F. HARLAND

SUBSCRIBED AND SWORN to before me this 5th day of December, 2014.

____
NOTARY PUBLIC IN AND FOR
THE STATE OF NEW MEXICO

OFFICIAL SEAL
Ronda Morehead
NOTARY PUBLIC
STATE OF NEW MEXICO
My Commission Expires: 7/5/15

My Commission Expires:
____

GCG # 518947