

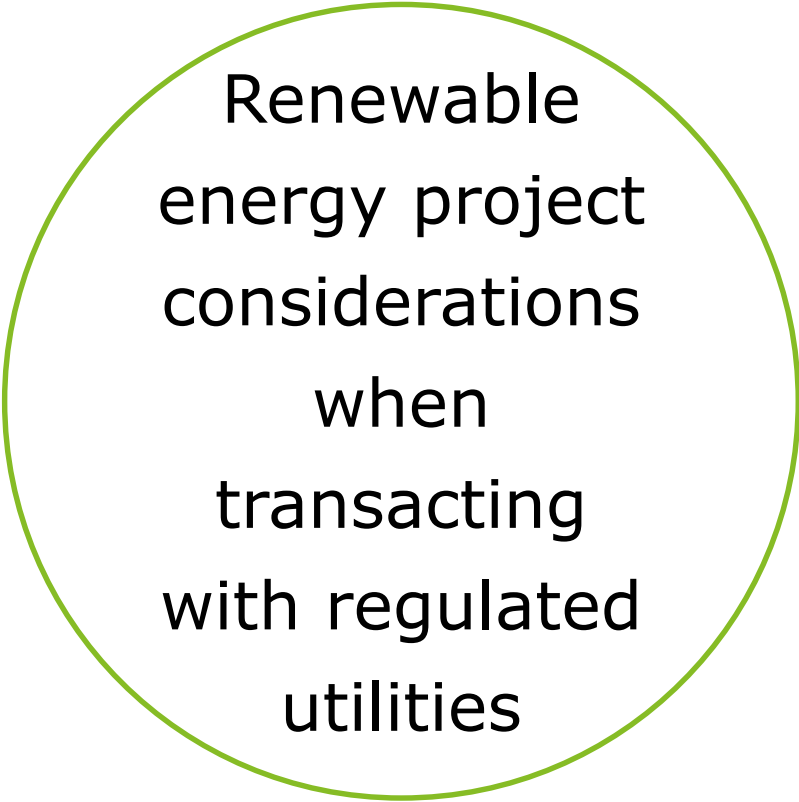


2017 Deloitte Renewable Energy Seminar

Innovating for tomorrow

November 13-15, 2017

Deloitte Center *for*
Energy Solutions



Renewable
energy project
considerations
when
transacting
with regulated
utilities

Renewable energy project considerations when transacting with regulated utilities

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How regulated utilities set rates

How regulated utilities set rates

The ratemaking formula

Rate base

x Allowed rate of return

= Required return (i.e., operating income)

+ Operating expenses (e.g., depreciation, taxes)

= Revenue requirement*

* Total amount which must be collected in rates for the utility to recover its prudently incurred costs and earn a fair return

How regulated utilities set rates

Rate base

- A measure of the amount of the utility's investors' investment in net utility plant and other items such as regulatory assets and working capital devoted to the rendering of utility service and upon which a fair return may be earned
- Potentially excludes CWIP, non-utility property, plant acquisition adjustment and plant held for future use
- Deductions from rate base are made for investments in net utility plant and other assets funded by others, such as customers and the government
- Analyze balance sheet
 - Funded by investors
 - Funded by others
- Methods for valuation of rate base
 - Investment (historical original) cost approach
 - Current value approaches
 - Historical or future test period

Rate-making Formula

Rate base

x Allowed rate of return

= Required return

+ Operating expenses

= Revenue requirement

How regulated utilities set rates

Rate of return

- Rate of return is the percent which the applicable regulatory commission finds should be earned on rate base in order to recover the cost of debt and equity
- The total dollar amount of return, or earnings, is calculated by multiplying the percentage rate of return by the utility's total dollar amount of rate base
- Returns are normally permitted, not guarantees or caps
- Analyze capital structure
 - May reflect accumulated deferred income taxes or accumulated deferred investment tax credit
- Utility's earned rate of return can vary from its authorized rate of return for a variety of reasons
 - Interest rate fluctuations
 - Inflation
 - Budgeting and cost-control efforts of the utility
 - Weather

Rate-making Formula

Rate base

x Allowed rate of return

= Required return

+ Operating expenses

= Revenue requirement

How regulated utilities set rates

Operating expenses

- Allowable operating expenses include operation, maintenance, depreciation and taxes
 - Interest expense is excluded from operating expenses because it is considered in the rate of return element of the formula
 - Referred to as above-the-line costs
- Analyze income statement
- Requirements for inclusion of costs in revenue requirement
 - Jurisdictional, utility vs. non-utility
 - Costs must be just and reasonable as well as prudently incurred
 - Cost adjustments must be known and measurable
 - Reflective of normal operations
 - Consistent with rate base and regulatory accounting

Ratemaking Formula

$$\begin{array}{r} \text{Rate base} \\ \times \text{ Allowed rate of return} \\ \hline = \text{ Required return} \\ + \text{ Operating expenses} \\ \hline = \text{ Revenue requirement} \end{array}$$

How regulated utilities set rates

Terminology

- **Required revenue** is the total amount which must be collected from customers in rates in order for the utility to recover its costs, including the allowed equity return
- **Rate design** refers to the allocation of the revenue requirement among the classes of customers
- Other terminology
 - Rate base v. base rates
 - Ratemaking formula v. formula rates
 - Rate case

Ratemaking Formula

$$\begin{array}{r} \text{Rate base} \\ \times \text{ Allowed rate of return} \\ \hline = \text{ Required return} \\ \hline + \text{ Operating expenses} \\ \hline = \text{ Revenue requirement} \end{array}$$

How regulated rates are set

Tax-on-tax gross-up formula–Federal income tax items and allowed equity return

- Required revenue is the total amount which must be collected from customers in rates in order for the utility to recover its costs, including the allowed equity return and income taxes
- Allowed equity return must be grossed-up for income taxes:

$$\frac{\text{Equity return}}{1 - \text{tax rate}^*} = \text{Pre-tax equity return}$$

* Based on composite statutory federal and state tax rates

- Example

- Allowed after-tax equity return = \$3,000,000
- Revenue requirement = $\$3,000,000 / (1 - 40\%) = \$5,000,000$
- Gross-up for income taxes = $\$5,000,000 - \$3,000,000 = \$2,000,000$

Roles of the state utility commissions

Renewable energy

- Determination of policy with respect to the use of green energy within the state
 - Renewable portfolio standards
 - State-specific requirements for rate-regulated utilities to meet certain energy targets using renewable sources
 - Mandatory v. voluntary
- Establish rates and recovery mechanisms for utilities to recover costs associated projects and investments
 - Cost-based
 - Incentive-based

How income taxes affect regulated rates

How income tax credits affect regulated rates

- Tax gross-up of federal income tax credits (35% federal income tax rate, no state income tax)
 - Recovering \$1 of federal income tax through rates requires \$1.54 of revenue (tax-on-tax effect)
 - Earning \$1 of federal income tax credits results in a \$1.54 reduction in the revenue requirement (i.e., savings to customers)

How income taxes affect regulated rates

Tax gross-up factors–Applications to increasing costs

- In the context of a rate case and assuming a 40 percent combined federal/state statutory tax rate*, what is the impact on the revenue requirement of a \$100 increase in the following items?

Item	Increase in Revenue Requirement
Property taxes or interest expense	\$100
Allowed after-tax equity return	\$167
Federal income tax	\$167
State income tax	\$108*

* Assumes a federal tax rate of 35 percent, a state tax rate of 7.7 percent and that federal income taxes are not deductible for state income tax purposes

How income taxes affect regulated rates

Tax gross-up factors

- A \$1 change in certain operating expense and return items has greater than \$1 change in revenue requirements

$$\text{Tax gross-up factor} = \frac{\text{Amount}}{1 - \text{tax rate}}$$

- Illustrations

Tax Rate	Tax Gross-up Factor	Tax Gross-up Factor
50%	÷ .50	2.00x
40%	÷ .60	1.67x
35%	÷ .65	1.54x
28%	÷ .72	1.39x
25%	÷ .75	1.33x
20%	÷ .80	1.25x
15%	÷ .85	1.18x

How income taxes affect regulated rates

Tax gross-up factors—Applications to decreasing income tax costs

- Assume an allowed after-tax equity return of \$3,000,000 and no PTCs. Further assume that the federal income tax rate decreases from 35 percent to 20 percent while the state income tax rate remains 7.7 percent. State income taxes are deductible for federal income tax purposes, but federal income taxes are not deductible for state income tax purposes. The change in federal income tax law does not affect the deductibility of state income taxes for federal income tax purposes. The former composite federal and state composite tax rate was 40 percent and the new composite tax rate is 26.16 percent.

Tax Gross-up before Tax Change	Tax Gross-up after Law Change	Decrease in Revenue Requirement
\$2,000,000	\$1,062,839	\$937,161

- Assume an allowed after-tax equity return of \$3,000,000 and no PTCs. The federal income tax rate decreases from 35 percent to 20 percent while the state income tax rate remains 7.7 percent. The change in federal income tax law also results in the disallowance of deductibility of state income taxes for federal income tax purposes. The new composite statutory federal and state tax rate is 27.7 percent.

Tax Gross-up before Tax Change	Tax Gross-up after Law Change	Decrease in Revenue Requirement
\$2,000,000	\$1,149,378	\$850,622

How income taxes affect regulated rates

Rate base components–Deferred tax liabilities

- Accumulated Deferred Income Taxes* – represents the deferred federal income taxes resulting from tax normalization and is considered a source of interest-free funds (i.e., cost-free capital) provided by the U.S. Treasury to the utility
- Ratemaking treatment
 - Accumulated deferred income taxes balance deducted from rate base, or
 - Accumulated deferred income taxes balance included in the capital structure of the utility at zero cost when computing the rate of return

*Referred to as Deferred Tax Liabilities under SFAS No. 109 and ASC 740. Also includes deferred state income taxes.

Ratemaking Formula

$$\begin{array}{r} \text{Rate base} \\ \times \text{ Allowed rate of return} \\ \hline = \text{ Required return} \\ \hline + \text{ Operating expenses} \\ \hline = \text{ Revenue requirement} \end{array}$$

Ratemaking and production tax credits (PTCs)

How income taxes affect regulated rates

Tax gross-up factors–Applications to federal and state PTCs

- Assume a federal income tax rate of 35 percent, a state income tax rate of 7.7 percent and that federal income taxes are not deductible for state income tax purposes (composite statutory federal and state tax rate of 40 percent)
 - What is the impact on the revenue requirement of earning \$100 of federal production tax credits?
 - What is the impact on the revenue requirement of earning \$100 of state federal production tax credits?

Item	Decrease in Revenue Requirement
Federal production tax credit	\$167
State production tax credit	\$108

How income taxes affect regulated rates

Tax gross-up factors—Applications to decreasing income tax costs

- Assume that a revenue requirement reflects \$3,000,000 of federal PTCs. Further assume that the federal income tax rate decreases from 35 percent to 20 percent while the state income tax rate remains 7.7 percent. State income taxes are deductible for federal income tax purposes, but federal income taxes are not deductible for state income tax purposes. The change in federal income tax law does not affect the deductibility of state income taxes for federal income tax purposes. The former composite federal and state composite tax rate was 40 percent and the new composite tax rate is 26.16 percent.

Item	Current Tax Law	New Tax Law
Federal PTC	\$3,000,000	\$3,000,000
Tax gross-up	2,000,000	1,062,839
Effect of PTC on Revenue Requirement	\$5,000,000	\$4,062,839

Reflecting PTCs in regulated prices

Background

- Ratemaking for PTCs and recording PTCs in the regulatory books of account are not subject to the normalization requirements
- Periodic rate cases based on expected/normal operations, including estimated PTCs
 - Base rates – normally re-set every few years
 - Based on projected financial information for a future test period or historical information from a recent prior period or a combination of both
- Rate riders (or trackers) – ratemaking mechanism to more frequently adjust rates for volatile cost items and provide a true-up mechanism
 - Examples include fuel costs, purchased power costs, demand side management costs
- Tax trackers
 - Examples – IRC Section 199 benefits, certain flowthrough items, tax uncertainties, tax credits
- Treatment of general business tax credit carryforwards

Reflecting PTCs in regulated prices

How to address volatility

- Including PTCs as part of base rates without a true-up provision
- Sharing PTCs through a rate adjustment clause (or tracker)
 - Reconciled periodically with the objective of ultimately reducing regulatory tax expense by the actual amount of PTCs
- Application to PTCs – example of a “PTC tracker”
 - Utility places a wind farm in service and considers the following in setting base rates
 - Investment in plant included in rate base
 - Regulatory depreciation expense recoverable in operating expenses
 - Annual projected PTC reduce recoverable tax expense
 - Record a regulatory asset if PTCs reflected in base rates exceed PTCs reported on tax return
 - Record a regulatory liability if PTCs reflected in base rates are less than PTCs reported on tax return

PTC adjustment clause

Example

- Commission sets base rates assuming \$10 million of federal PTC annually
 - Federal tax rate is 35%, federal/state composite tax rate is 40%
- A tracking mechanism is used to adjust rates in a future period if the amount of PTC reported on the tax return differs from the amount reflected in base rates
- For a given year, the amount of PTC reported on the tax return is \$9 million (less than the amount reflected in prices charged)
 - Record a regulatory asset if PTCs reflected in base rates exceed PTCs reported on tax return

DR	Taxes payable	9,000,000
DR	Regulatory asset (\$1 million + tax gross-up)	1,666,667
CR	Tax benefit (PTC)	10,000,000
CR	Deferred tax liability (on regulatory asset)	666,667

To record the amount of PTC realized and the amount needed to be reflected in rates in a future year due to reducing rates by more PTC than was generated in the current year

PTC adjustment clause Example (continued)

- In a subsequent year, the regulatory asset is recovered from customers

DR	Accounts receivable	1,666,667	
CR	Revenue		1,666,667
DR	Current tax expense	666,667	
CR	Taxes payable		666,667
DR	Deferred tax liability (on regulatory asset)	666,667	
DR	Tax benefit (PTC)	1,000,000	
CR	Regulatory asset		1,666,667

To record the incremental revenue charged in the subsequent year in order to recover the regulatory asset recorded in a prior year related to the reduction of base rates in the prior year by more PTC that was generated in the prior year

Ratemaking restrictions for investment tax credit (ITC)

Ratemaking restrictions for investment tax credit (ITC)

ITC normalization requirements–Background

- Normalization provisions require ITC benefits to be shared between
 - Utilities and ratepayers
 - Generations of ratepayers
- ITC benefit is spread over the regulatory life of property
 - Two main options are available for ratemaking
 - IRC Section 50(d), former IRC Section 46(f) and Treas. Reg. Section 1.46-6
- Rules are mandatory with sanctions for violation
 - ITC – Tax Reform Act of 1986 Section 211(b)
 - Deferred taxes – IRC Sections 168(f)(2) and 168(i)(9)(C) and Treas. Reg. Section 1.167(l)-1(h)(5)
 - Public utility property placed in service after February 13, 2008, in tax years ending after such date, qualifies for the IRC Section 48 energy credit
- Legislative intent – “subject to” v. “protected by”

ITC normalization requirements

Options for reflecting ITC in regulated rates

- The accounting and ratemaking treatment for ITC is largely dictated by former Internal Revenue Code (IRC) Sections 46(f)(1) and 46(f)(2)
- The IRC permits sharing of ITC benefits between utility investors and customers either as
 - Option 1 - ADITC rate base reduction, with no amortization through operating expenses (i.e., regulatory income tax expense)
 - Amortization must be no less rapidly than ratably over the regulatory depreciable lives of the related property
 - Option 2 - Amortization of ITC “above-the-line” as a reduction in regulatory income tax expense
 - No rate base reduction
 - Amortization must be no less rapidly than ratably over the regulatory depreciable lives of the related property
 - Option 2 deferred ITC should earn at least the overall cost of capital if included in the capital structure

Ratemaking Formula

$$\begin{array}{r} \text{Rate base} \\ \times \text{ Allowed rate of return} \\ \hline = \text{ Required return} \\ \hline + \text{ Operating expenses} \\ \hline = \text{ Revenue requirement} \end{array}$$

Impact of ITC on regulated rates (Option 1)

Wages/salaries

Pension expense

Depreciation expense

Current FIT expense

Deferred FIT expense

<Refund of excess deferred taxes>

Fuel expense

Decommissioning costs

Other costs

Operating expenses

Plant

<Accumulated depreciation>

<Accumulated deferred FIT>

<Accumulated deferred ITC>

Rate base

X Rate of return

Operating income (return)

Revenue requirement

Impact of ITC on regulated rates (Option 2)

Wages/salaries
Pension expense
Depreciation expense
Current FIT expense
Deferred FIT expense
<Refund of excess deferred taxes>
<ITC amortization>
Fuel expense
Decommissioning costs
Other costs

Plant
<Accumulated depreciation>
<Accumulated deferred FIT>

Operating expenses

Rate base
X Rate of return

Return (operating income)

Revenue requirement

Definition of “public utility property”

Deferred tax and ITC normalization requirements

- The IRS has ruled that the definitions of “public utility property” are the same for ITC normalization purposes and deferred tax normalization purposes
 - IRC Section 168(i)(10) and Treas. Reg. Section 1.167(l)-1(b)(1)
 - Former IRC Section 46(f)(5) and Treas. Reg. Section 1.46-3(g)(2)(iii)
- Three factors in determining whether property is public utility property
 - The property must be used predominantly in the trade or business of the furnishing or sale of electrical energy, gas or steam through a local distribution system, gas or steam by pipeline, water, sewage disposal services or certain telephone or communications services
 - The rates for such furnishing or sale must be established or approved by a State or political subdivision thereof, any agency or instrumentality of the United States, or by a public service or public utility commission or similar body of any State or political subdivision thereof
 - The rates so established or approved must be determined on a rate-of-return basis

Definition of “public utility property”

Recent private letter rulings

- Rulings

- PLR 201544018

- PLR 201619005

- PLR 201718017

- PLR 201722006

- Holdings

- The facilities at issue were held not to be “public utility property” due to the pricing arrangements applicable to the power generated by the facilities

Definition of “public utility property”

PLR 201544018–Facts, issue, and holding

- Vertically-integrated electric utility subject to rate regulation by three commissions
- “Non-jurisdictional rates” established by bi-lateral negotiations with certain customers
 - Customers are primarily government agencies or entities
- Currently, the provision of electricity to government installations from system assets with no significant assets entirely dedicated to service to this customer
- Proposal to provide power generated by a solar facility delivered over a transmission system controlled by an RTO
- Issue – is the solar facility “public utility property” (i.e., subject to the ITC and deferred tax normalization requirements)?
 - Because the rates are determined solely by negotiations between a buyer (Department) and a seller (Taxpayer) rather than being established or approved by a governmental entity through a regulatory process on a rate-of-return basis, the rates are not "established or approved" within the meaning of the normalization rules, notwithstanding that Department is a United States governmental agency. Therefore, Facility is not public utility property within the meaning of those provisions

Definition of “public utility property”

PLR 201619005–Facts and issues

- Vertically-integrated electric utility subject to rate regulation by three commissions
- Three methodologies to set prices for portions of three solar generation facilities
 - Market Index rate adjustment clause
 - Recovery of its costs based on a market index rather than a more traditional cost of service model
 - Annual true-up, but not differences between projected and actual costs
 - Non-jurisdictional retail customers – generally governmental entities
 - Rates established by means of bi-lateral negotiations between Taxpayer and each customer
 - Wholesale customers – rates established by negotiation or the wholesale market
- Issues – for each pricing arrangement, does the portion of each solar facility constitute “public utility property” (i.e., subject to the ITC and deferred tax normalization requirements)?

Definition of “public utility property”

PLR 201619005–Holdings

- Rates determined under a market index – not set on a rate-of-return basis
- Bi-lateral negotiations – not established or approved by a public utility commission and are not determined on a rate-of-return basis
- Rates determined through negotiation and/or by the wholesale market index – not set on a rate-of-return basis

Definition of “public utility property”

PLR 201718017–Facts

- Vertically-integrated electric utility subject to rate regulation by two commissions
- Voluntary community solar pilot program designed to allow residential, commercial, or industrial customers the choice of participating in and receiving the benefits of a solar photovoltaic electrical generating facility
 - Solar facility will not be included in the determination of revenue requirements for base rates in any regulatory rate filings
 - Participants will not be entitled to any energy generated by the solar facility and will continue to be billed for their energy consumption at commission-approved retail electric rates
 - Energy from the solar facility sold to the utility’s general body of customers will be recovered through the utility’s fuel clause with no return earned on the investment from base rates or a cost recovery clause
 - Participants will pay an annual subscription fee in exchange for a monthly incentive fee from the utility (in the form of a line item credit on the regular monthly bill) intended to compensate Participants for the
 - Energy output of the Facility based on the utility’s avoided fuel charge
 - Retirement of any renewable energy certificates associated with the Facility

Definition of “public utility property”

PLR 201718017–Issue and holding

- Issue – whether the solar facility will be “public utility property” within the meaning of the ITC and deferred tax normalization requirements
- Holding – the facility will not be “public utility property” within the meaning of IRC Section 168(i)(10) and former IRC Section 46(f)(5) because
 - None of the payments for the electrical energy produced by the facility at the avoided fuel charge (market rate) constitutes a payment for the furnishing or sale of electrical energy at a price that reflects cost-based, rate-of-return ratemaking, and
 - The subscription fee is not for the furnishing or sale of electrical energy from the facility

Definition of “public utility property”

PLR 201722006–Facts

- Peaking generation facility is owned by a corporation that is not described as a regulated public utility
 - Wholesale power provider subject to the Federal Power Act – to the extent its sales are under the jurisdiction of the applicable commission, its rates are established through negotiation and/or by the wholesale market
 - Not subject to regulation by the state public service commission; however, merchant generators could agree contractually to submit to rate determinations
- Taxpayer's predecessor in interest entered into a contract with a regulated electric distribution company over which the commission exercises ratemaking jurisdiction
 - Commission will determine a revenue requirement, including a review of cost of service, in annual contested proceedings
 - The allowed return on equity will be indexed to an average of the returns approved for unrelated electric distribution companies
 - Limited portions of rate base and expense are reconciled to actual expenses (a “true-up” process)
 - Any premium above book value received upon the sale of the facility shall be paid to the utility

Definition of “public utility property”

PLR 201722006–Issue and holding

- Issue – whether the facility is, in whole or in part, public utility property within the meaning of the deferred tax normalization requirements
- Holding – the facility is not public utility property within the meaning of IRC Section 168(i)(10)
 - The determination of amounts to be received by the taxpayer under the contract, while containing some elements in common with the determination of rates for the furnishing or sale of electrical energy established or approved by a State or political subdivision thereof, such rates being determined on a rate-of-return basis, does not, under these facts, satisfy the second and third factor

Definition of “public utility property” private letter rulings

No opinion is expressed or implied concerning other Federal income tax consequences

- Whether the contract to sell electricity constitutes a service contract under IRC Section 7701(e)
 - PLRs 201544018, 201619005, 201718017
- Whether the Taxpayer is the owner of the Facility generating electricity for federal income tax purposes
 - PLRs 201544018, 201619005, 201718017
- The classification of the property under IRC Section 168(e) (depreciable recovery period)
 - PLRs 201619005, 201718017
- Other subsections of IRC Section 168
 - PLRs 201619005, 201718017

Proposal to make ITC normalization rules elective for solar H.R. 5440 (introduced June 9, 2016)

- Bill would amend the Internal Revenue Code to allow certain regulated companies to elect out of the public utility property energy investment tax credit limitation in the case of solar energy property
- Election would be made on a property-by-property basis on a timely filed return for the taxable year in which such property is placed in service
 - Revocable only with consent of the Secretary of the Treasury
- No such election may be made by the taxpayer if such election is required by its commission
- Would be effective to property placed in service after December 31, 2015

Proposal for elective payment for specified energy property

H.R.4599 – Renewable Energy Expansion Act of 2010 (introduced February 4, 2010)

Legislative proposal to limit the application of the normalization requirements to projects owned by utilities not subject to RPS thresholds

APPLICATION OF NORMALIZATION RULES. -- Paragraph (2) of section 50(d) shall not apply with respect to property placed in service by a person in the trade or business of furnishing or selling electrical energy if any law or regulation requires that not less than a certain amount of the electrical energy so furnished or sold by such person be derived from one or more renewable resources.

Accounting considerations for ITC

Accounting considerations for ITC

- Basic recognition methods
 - Flow-through – immediate recognition
 - Deferral – amortization over the GAAP depreciable life
- Balance sheet presentation
- Temporary differences
 - Unamortized deferred ITC (or book basis reduction)
 - Tax basis reductions
- Interim reporting

Owning a renewable energy facility

Tax accounting policy decisions

- Accounting for the deferred grant as a reduction to plant basis or as deferred revenue
 - Option 2 companies
 - Impact on property taxes?
- Deferred tax benefit associated with the net DTA for the basis reductions
 - Why rate-regulated utilities should not immediately recognize as the deferred tax benefit

ITC accounting guidance

Deferral method vs. flow-through method (emphasis added)

- ASC 740-10-25-45

- An investment credit shall be reflected in the financial statements to the extent it has been used as an offset against income taxes otherwise currently payable or to the extent its benefit is recognizable under the provisions of this Topic.

- ASC 740-10-25-46

- While it shall be considered **preferable** for the allowable investment credit to be reflected in net income over the productive life of acquired property (the **deferral method**), treating the credit as a reduction of federal income taxes of the year in which the credit arises (the **flow-through method**) is also **acceptable**.

- Pre-codification guidance

- APB Opinion No. 2

- APB Opinion No. 4

- SFAS No. 109, paragraphs 5(a), 11(e), 11(f), 116, 117

ITC recognition accounting policies

Examples

- Investment tax credits (ITCs) are deferred and amortized to income over the approximate lives of the related property.
- In accordance with regulatory requirements, ITCs are deferred and are amortized over the life of the related property with such amortization applied as a credit to reduce current income tax expense in the statement of income.
- We amortize deferred investment tax credits over the lives of the related properties as required by tax laws and regulatory practices.
- Federal ITCs utilized are deferred and amortized to income over the average life of the related property.
- Investment tax credits are accounted for under the flow-through method except where regulatory commissions have reflected investment tax credits in the rate-making process on a deferral basis. Investment tax credits that have been deferred are amortized over the life of the plant investment.
- Deferred ITC is amortized to income tax expense over the life of the asset. Amortization of deferred ITC begins when the asset is placed into service, except where regulatory commissions reflect ITC in the rate-making process, then amortization begins when the cash tax benefit is recognized.

Deferred ITC

Balance sheet presentation

- ASC 740-10-45-27
 - The reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account) **may be preferable in many cases.** However, it **is equally appropriate** to treat the credit as deferred income, provided it is amortized over the productive life of the acquired property.
- Reduction of depreciable basis of asset
- Accumulated deferred investment tax credits
 - FERC Account 255
 - Most common method by utilities
- Regulatory liability
 - Companies with accounting policies to flow through ITC unless required to defer under tax law or PUC orders deferral/amortization

Impact of renewable energy investments on rates

Impact of renewable energy investments on rates

- Long-term power purchase agreements (PPAs)
- Owning a generation facility
 - Direct ownership
 - Ownership by an unregulated affiliate
 - Investment through a partnership

Impact of renewable energy investments on rates and financial reporting

	Long-term PPA	Plant ownership
Amounts included in operating costs	Purchase price for power	Depreciation, repairs, taxes, etc.
Impact of PTC and ITC on regulatory tax expense	None	PTC and Option 2 ITC reduce recoverable income tax on a grossed-up basis
Amounts included in rate base	None	<ul style="list-style-type: none"> • Undepreciated book value of plant. • If Option 1 ITC, reduce rate base by unamortized ITC.
Impact on equity return, book income, EPS	None	Increase (relative to a PPA)

Impact of renewable energy investments on rates

Issues in evaluating whether to buy or build

- Impact to shareholders
- Impact to ratepayers
- Request for proposals and regulatory approval process

Whether to build or buy a power plant and seeking regulatory approval

How unregulated power producers model power plant investment and PPA opportunities

- Cash flow modeling
 - PTC v. ITC Income taxes are “just another cash flow”
 - Impact on return available to tax investors
 - Determining the flip point
- Bidding against other IPPs v. the local utility
 - Minimum acceptable return
 - Slightly lower than the price resulting from application of the normalization requirements

How regulated utilities model investment and PPA opportunities

- Modeling whether PTC or ITC are more attractive to
 - Ratepayers
 - Shareholders
- RFP to assess whether plant ownership or PPA is more advantageous to
 - Ratepayers
 - Shareholders
- Determining whether the generation facility is “public utility property” for purposes of the normalization requirements

Normalization considerations

- Are there structures that can be employed to avoid application of the normalization requirements by regulated utilities and the companies in which they invest?
 - Indirect normalization violations
 - Any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service or rate base
 - Reg. Sec. 1.46-6(b)(4)
 - Seeking a private letter ruling from the Internal Revenue Service
 - Pre-submission conference

Utility investments in partnerships owning renewable generation facilities

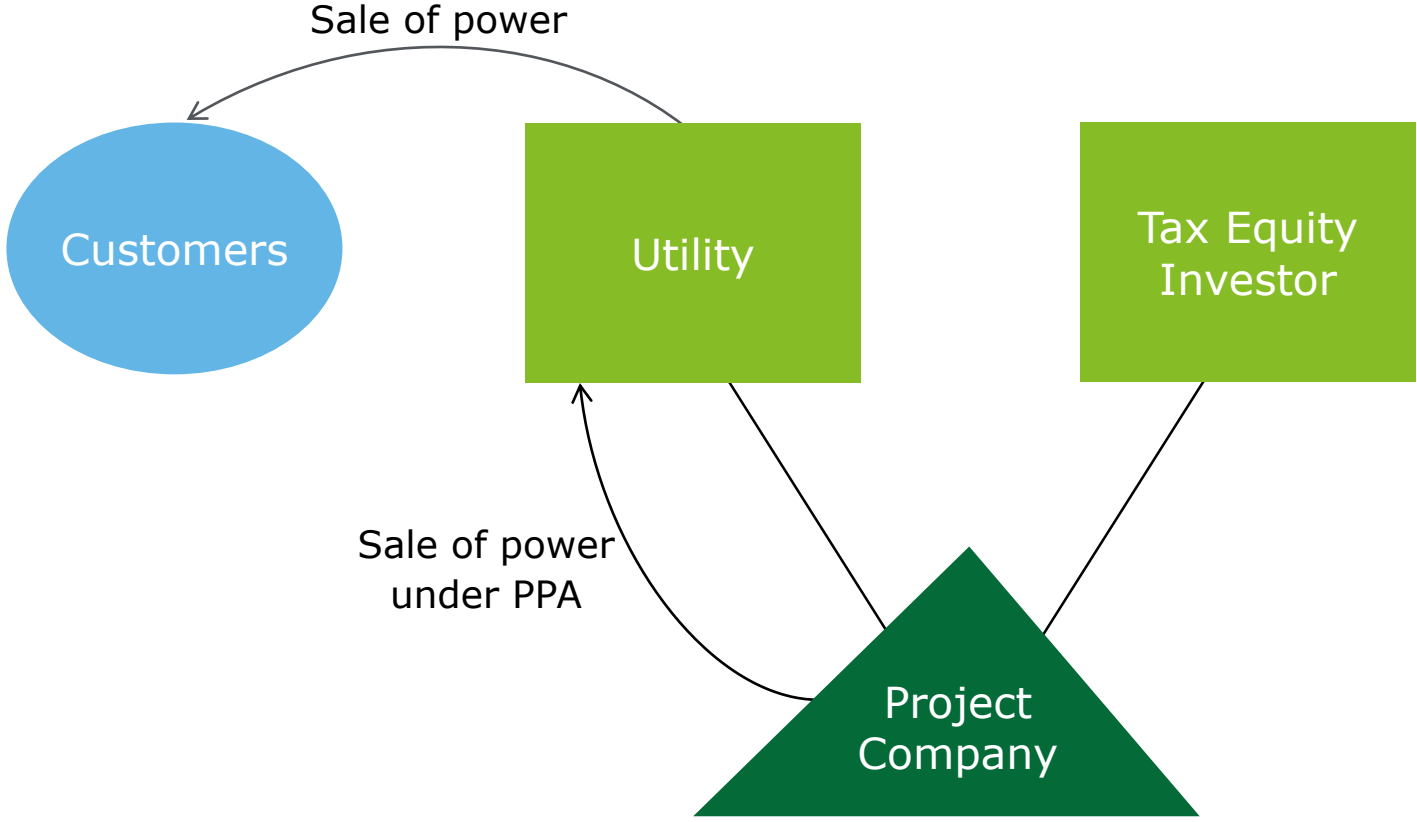
Utility investments in renewable energy partnerships

Background

- Due to bonus depreciation and other reasons, many utilities have NOL carryforwards and are not able to utilize PTCs or ITCs currently
- Investments in partnerships owning renewable generation plants by utilities and tax equity investors
- Objectives
 - Utilize credits rather than carry credits forward
 - Avoid ratemaking based on application of the normalization requirements
- Ratemaking for investments in partnerships

Recovery of income tax expense through rates

Forms of organizational structure



Utility investments in renewable energy partnerships

Tax issues

- Requirement that power be sold to unrelated parties – IRC Section 45(a)(2)(B)
- Loss disallowance upon sale of property between certain related parties – IRC Sections 707(b) and 267(d)
 - Sales or exchanges of “property”
 - Application of Section 263A
- Whether deferred taxes and any ITC related to the (unregulated) power plant owned by the project company (partnership) are subject to the normalization requirements

Financial reporting considerations

Financial reporting considerations

Rate case settlements

- Rate cases often result in settlements between the utility and regulator
- Determining the appropriate accounting for a settled rate case can sometimes be challenging when the extent of the information included in the settlement agreement is limited
- Settlements could result in disallowances, impairments, etc.
- Utility companies must therefore exercise significant judgment to determine the appropriate accounting for a settled rate case

Financial reporting considerations

Disallowances—ASC 980-360

- Direct disallowances
 - No or reduced cost recovery is provided for all or a portion of recently completed plant
 - When probable and estimable, the estimated amount of the probable disallowance must be deducted from the reported cost of the plant and recognized as a loss
 - Future depreciation charges should be based on the written-down asset basis
- Indirect disallowances
 - No return or a reduced return is provided for all or a portion of the recently completed plant
 - If the regulator does not specify the amount of the disallowance, the amount must be calculated on the basis of estimated future cash flows and recognized as a loss
 - The remaining asset should be depreciated in a manner consistent with the ratemaking and in a manner that would produce a constant return on the undepreciated asset that is equal to the discount rate
- Disallowances on plants that are not recently completed would apply the impairment criteria of ASC 360

Financial reporting considerations

Phase-in plans–ASC 980-340

- General rule – an incurred cost that is probable of recovery in future rates shall be not be expensed, but instead recorded on the balance sheet as a regulatory asset
- Exception to general rule – if the incurred cost relates to major, newly completed plant, it may not qualify as a regulatory asset
 - In essence, a phase-in plan exists when costs related to new plant (such as depreciation and O&M) are reflected in rate recovery more slowly than when those amounts would be expensed under GAAP
- Financial reporting
 - Costs may not be deferred
 - Lower earnings during the years that revenues are reduced and higher earnings in years that revenues are increased to recover costs incurred in the earlier years
- If regulator permits deferral of costs related to a new plant until an upcoming rate case, those amounts can typically be deferred
- Examples to analyze – ratemaking proposals involving levelized rents for many years

Questions?





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