Davicel Avellan

Direct Testimony and Exhibits

<u>BEFORE THE NEW MEXICO PUBLIC REGULATION COMMISSION</u>

IN THE MATTER OF THE APPLICATION	**)**	
OF NEW MEXICO GAS COMPANY, INC.	**)**	
FOR APPROVAL OF REVISIONS TO ITS	**)**	
RATES, RULES, AND CHARGES PURSUANT	**)**	**Case No. 19-00317-UT**
TO ADVICE NOTICE NO. 78	**)**	
	)	
NEW MEXICO GAS COMPANY, INC.	**)**	
	)	
Applicant.	**)**	

DIRECT TESTIMONY AND EXHIBITS

OF

DAVICEL AVELLAN

December 23, 2019

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Davicel Avellan. I am the Director of Regulatory Plant and Tax Accounting for Tampa Electric Company ("Tampa Electric") a wholly-owned subsidiary of TECO Energy, Inc. ("TECO"), which is a wholly-owned subsidiary of Emera Inc. My business address is 702 North Franklin Street, Tampa, Florida 33602.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND, WORK EXPERIENCE AND PRIOR TESTIMONY.

A. I have been employed by TECO for 25 years. My primary focus during the last 19 years has been in Corporate Income Taxes where I have gained utility tax industry knowledge and experience. I manage the entire Federal and State income tax function for the regulated utilities owned by TECO: Tampa Electric, Peoples Gas System, and New Mexico Gas Company, Inc. ("NMGC" or "Company"). In my career I have provided tax support in various gas and electric regulatory proceedings.

My professional experience and education are described in NMGC Exhibit DA-1.

Q. PLEASE DESCRIBE YOUR DUTIES AND RESPONSIBILITIES IN YOUR POSITION.

A. I am responsible for providing tax services to NMGC, Peoples Gas System and Tampa Electric. My responsibilities include the preparation and filing of tax returns, tax accounting for internal and external purposes, tax planning, and managing federal and state income tax audits. I am also responsible for overseeing all the regulatory capital asset accounting and reporting for Tampa Electric and Peoples Gas Systems.

Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?

A. My direct testimony covers the following areas:

- I am sponsoring certain schedules required by 17.10.630 NMAC ("Rule 630"), including Rule 630 Schedules H-9, H-10, H-11, H-12 and H-13, related to the income tax computations.,
- I discuss the normalized income tax accounting methods used by NMGC, 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 functionality of the calculation of Accumulated Deferred Income Taxes ("ADIT"), and income tax expense as they relate to the cost of service model used in this proceeding.
- I discuss the Base Period (July 1, 2018 through June 30, 2019) to Future Test Year (January 1, 2021 through December 31, 2021), adjustments to ADIT, income tax expense, and current taxable income.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.

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, and future test periods should be strictly followed. This case as filed meets all these requirements and accurately and fairly calculates both ADIT and income tax expense in the Base Period and Future Test Year.

Q. PLEASE DESCRIBE THE PURPOSE OF RULE 630 SCHEDULES H-9 THROUGH H-13.

A. Rule 630 Schedule H-9 shows the calculation of Federal and State income tax expense for the Base Period, Linkage Periods (the period between July 1, 2019 through December 31, 2020), and the Future Test Year. The calculation of income tax expense in Rule 630 Schedule H-9 is used in the determination of revenue requirements.

Rule 630 Schedule H-10 reconciles book income and current taxable income for the Base Period, Linkage Periods, and the Future Test Year. The calculation of current taxable income is purely informational, and is not included in the cost of service, as it does not affect the total tax expense recoverable in rates.

Rule 630 Schedule H-11 requires an analysis of the tax effects from filing a consolidated federal income tax return. I provide this analysis in my testimony below.

Rule 630 Schedule H-12 provides detail of the ADIT activity for the 12 months ended June 30, 2019 and ADIT balances for the Base Period, Linkage Periods, and the Future Test Year. 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. NMGC Exhibit DA-2 provides the ADIT balances from the Base Period, Linkage Periods and Future Test Year included in Rule 630 Schedule H-12.

We considered the requirements of Rule 630 Schedule H-13 and determined that since NMGC does not have any investment tax credits this is not applicable for this case.

Q. PLEASE DESCRIBE THE CALCULATION OF INCOME TAX EXPENSE ON RULE 630 SCHEDULE H-9.

A. Rule 630 Schedule H-9 calculates the income tax expense allowable in rates for the Base Period, Linkage Periods, and the Future Test Year. 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. 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 reversal of excess deferred income taxes.

Q. IS THE INCOME TAX EXPENSE IN THE COST OF SERVICE CALCULATED 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 NMGC rate applications and prior Commission orders.

I. INCOME TAX NORMALIZATION, ADIT, AND NOLS

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

A. NMGC uses the normalization method.

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.

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 considering 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, from the ratemaking perspective, 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 as a reduction in rate base ensures that customers receive the benefits of this cost-free capital.

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

A. 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 to calculate the tax expense related to depreciation-related temporary differences. Additionally, the temporary differences resulting from CIAC are specifically required to be normalized under IRS Notice 87-82, as discussed in IRS Private Letter Ruling ("PLR") 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 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.

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 tax payable actually exceeds the tax expense recorded for book purposes. This excess tax will be returned to the Company over time as the underlying asset is depreciated. In such a case, because we are paying the tax now, instead of in the future, an ADIT asset is created. The theory and treatment are 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. In this case, NMGC has a net liability on their books that is a reduction in rate base.

Q. WHEN DISCUSSING NORMALIZATION, YOU HAVE USED THE TERMS "PERMANENT AND TEMPORARY DIFFERENCES." PLEASE

EXPLAIN THE DIFFERENCES STARTING WITH PERMANENT DIFFERENCE.

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 and entertainment expenses are generally deductible. For tax purposes, however, only 50% of meals and entertainment expenses are considered deductible, as I discuss further in my testimony below. The difference between the book deductibility and the tax deductibility is absolute and permanent, and not merely related to the timing of the deduction. Therefore, tax expense must be increased by the book tax expense on the non-deductible 50% of these expenses.

Q. PLEASE EXPLAIN THE TERM "TEMPORARY DIFFERENCE" AS IT RELATES TO THE NORMALIZATION.

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 income 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, accelerated depreciation may be used for tax purposes while the straight-line method is used for calculating book depreciation expense. In that instance, 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. 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. These adjustments are made on Rule 630 Schedule H-9 and in the cost of service.

Q. WHAT IS NMGC'S CURRENT STATUS WITH REGARD TO NET OPERATING LOSSES ("NOL")?

A. NMGC is currently in an NOL carryforward position.

Q. WHY IS NMGC IN AN NOL CARRYFORWARD SITUATION?

A. An 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 have often resulted in tax depreciation deductions so large that they created negative current taxable income.

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 are 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. For these reasons, the Company elected to take bonus depreciation, which resulted in a benefit to its customers.

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 actually received by the Company.

Q. HAS NMGC INCLUDED AN NOL CARRYFORWARD ADIT ASSET IN RATE BASE IN THE BASE PERIOD, LINKAGE PERIODS, AND FUTURE TEST YEAR?

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

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

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

> In respect of any taxable year the use of a method of depreciation other than a subsection (1) 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 (1) 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.

PLRs 201436037, 201436038, 201438003, 201519021, 201534001, and 201548017 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 an NOL carryforward, the NOL carryforward ADIT asset would constitute a normalization violation.

Q. IS THIS CONSISTENT WITH THE IRS'S POSITION ON THE TREATMENT OF NOLS IN RATEMAKING PROCEEDINGS?

A. Yes, it is. The IRS view is that the NOL carryforwards that are required to be normalized are calculated using a "with-and-without" approach. This means that the IRS considers an NOL to be created first by accelerated tax deprecation (including bonus tax depreciation). Only to the extent the NOL is larger than the accelerated tax depreciation deductions is it considered to have been created by other tax deductions. Therefore, the IRS considers all of the NMGC NOL carryforward to have been created from accelerated tax depreciation, specifically bonus tax depreciation.

Q. PLEASE DISCUSS THE SIX RECENT PLRS MENTIONED ABOVE.

A. These six PLRs are pertinent because they deal with facts almost identical to those in this case. Before the introduction of bonus tax depreciation, very few regulated utilities incurred NOLs on a stand-alone basis. This accounts for the lack of PLRs on the issue of NOL carryforward ADIT normalization prior to 2014. With the enactment of bonus tax depreciation, NOLs have become much more common for utilities in recent years. As a result, several utilities have sought PLRs regarding NOL carryforward ADIT normalization. All six of the referenced 2014 and 2015 PLRs relate to whether NOL carryforward ADIT assets are required to be included as a reduction in rate base, and how to calculate the required includible amount.

Q. WHAT CONCLUSIONS DO THESE PLRS REACH?

A. These six 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" or "last dollar deducted" approach. In other words, accelerated tax depreciation is considered to be the last expense deducted, and the hypothetical taxable income of the utility is calculated with and without accelerated tax depreciation deductions.

The change in the taxable loss resulting from this calculation 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 case. All six PLRS contain essentially the following language:

> Because the ADIT account [Account 282], the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an 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.

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.

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

A. Yes, it is. This treatment assures that NMGC customers receive the benefits of the actual deferred tax payments, no more and no less. Including 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. If the NOL carryforward ADIT asset was not included as an addition to rate base this cash-savings benefit would be greatly overstated, and customers would benefit unjustly from cash savings not yet realized by the utility.

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

A. Yes. 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, Treasury Regulation § 1.167(1)-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 pro-rated.

Q. PLEASE DISCUSS THESE FUTURE TEST YEAR NORMALIZATION REQUIREMENTS.

A. Under Treasury Regulation § 1.167(1)-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 over the period for which the new rates are expected to be in effect.

In this filing, the future period is the year ending December 31, 2021. Collection of the new rate is expected to start on January 1, 2021. Therefore, the new rates are expected to be in place for the entirety of the Future Test Year. As a result, January through December 2021 utility plant ADIT additions must be pro-rated. The Future Test Year utility plant ADIT additions are pro-rated using a ratio in which the numerator is the number of days remaining in the Future Test Year, and the denominator is the number of days during which the new rates are expected to be in effect in the Future Test Year. Because NMGC closes its books on a monthly basis, the proration is also done on a monthly basis. As a result, January 2021 ADIT additions are prorated using a ratio of 335/365, February 2021 ADIT additions are prorated by 307/365, and so on until December 2021 additions are prorated by 1/365.

Q. MUST A PRORATION BE DONE IF RATE BASE IS DETERMINED USING AVERAGE TEST-PERIOD BALANCES?

A. Yes. IRS rules state that a proration must be done even when average rate base is used. The proration must be done first, before the averaging methodology is applied. The averaging methodology is then applied to the prorated balances.

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

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

WHAT PERIOD WAS USED TO DEVELOP THE BASE PERIOD ADIT AND TAX EXPENSE?

A. The Base Period reflects the ADIT balances as of June 30, 2019 and the tax expense reflects the 12 months ended on that date. The Base Period ADIT, permanent and flow-through book/tax differences, tax credits, and other tax adjustments come from the Company's financial accounting books and records. The only adjustments made to Base Period ADIT are the Model-Driven Calculations, discussed below. All other adjustments discussed below were made in the development of the Adjusted Base Period.

Q. WHAT ADJUSTMENTS WERE MADE IN DETERMINING THE ADJUSTED BASE PERIOD AND ADJUSTED LINKAGE PERIODS ADIT BALANCES?

A. ADIT adjustment have been made to the Base Period and Linkage Periods balances where necessary to synchronize ADIT with underlying rate base items. These include:

- Model-Driven Calculations-ADIT balances that relate to regulatory assets and liabilities and other rate base items were trued-up to equal the balance of the underlying account multiplied by the combined Federal and State rate that is calculated.
- ADIT balances on certain regulatory assets and liabilities are adjusted to synchronize with the adjustments to the underlying regulatory assets and liabilities shown on NMGC Exhibit DA-3. The following ADIT changes are shown on Rule 630 Schedule H-12, pages 9-12:

- remove ADIT Asset for Start-up and Organizational Costs;
- remove ADIT for Amortization of Start-up & Organizational Costs;
- remove ADIT for Amortization of Goodwill; and
- remove ADIT for Non-Utility Other Income and Deductions.

Q. WHAT ADJUSTMENTS WERE MADE IN DETERMINING ADJUSTED BASE PERIOD AND ADJUSTED LINKAGE PERIODS INCOME TAX EXPENSE?

A. Several items in the income tax expense calculation were adjusted to arrive at the Adjusted Base Period and Adjusted Linkage Periods income tax expense. These items are as follows:

- non-deductible permanent book/tax differences including club dues, political contributions, lobbying expense, and fines and penalties;
- the flow-through difference for AFUDC Equity; and
- Federal and State Excess Deferred Income Tax reversals.

II. FUTURE TEST YEAR CALCULATIONS AND ADJUSTMENTS

Q. ARE THE ADIT AND INCOME TAX EXPENSE CALCULATIONS IN THE COST OF SERVICE MODEL "FULLY FUNCTIONAL," AS DESCRIBED IN THE FUTURE TEST YEAR RULE?

A. No, they are not. It is not feasible to make income tax and ADIT calculations fully functional in a Microsoft Excel model, due to the complexity of the interaction among income tax laws and GAAP reporting requirements. Changes to ADIT and income tax expense adjustments (such as permanent and flow-through book/tax differences and income tax credits) must be determined outside the cost of service model and then manually input. Therefore, in accordance with 17.1.3.11 NMAC, NMGC will rerun the calculations reasonably required by Staff or intervenors in order to capture the impact on the proposed cost of service of any adjustments to ADIT or other income tax input.

Q. HOW HAS NMGC CALCULATED THE ADIT INCLUDED IN THE FUTURE TEST YEAR COST OF SERVICE?

A. The calculated incremental ADIT included in the Future Test Year revenue requirements is calculated at the applicable combined Federal and State income tax rates in effect for the Future Test Year. The changes in ADIT are calculated by applying the applicable tax rates to the changes in the underlying book/tax differences on rate base accounts, be they plant-in-service, regulatory assets or liabilities, or other rate base items. Additionally, certain ADIT accounts are adjusted for “tax-only” differences, including repairs deductions, NOL carryforwards, average rate assumption model (“ARAM”) reversals, and depreciation flow-through reversals. All the Future Test Year adjustments are discussed in more detail below.

Q. WHAT ADJUSTMENTS WERE MADE TO ADIT IN THE FUTURE TEST YEAR?

A. ADIT for the Future Test Year has been adjusted for the following:

- The IRS-required proration of depreciation-related ADIT discussed previously in my testimony. These adjustments are embedded in the monthly Future Test Year balances shown on Rule 630 Schedule H-12 pages 5-8. Such inclusion in the monthly balances is necessary due to the use of an average test period rate base in this case;
- The following ADIT changes are shown on Rule 630 Schedule H-12, pages 11-12:
    - remove ADIT Asset for Start-up and Organizational Costs;
    - remove ADIT for Amortization of Start-up & Organizational Costs;
    - remove ADIT for Amortization of Goodwill; and
    - remove ADIT for Non-Utility Other Income and Deductions.

Q. WHAT ADJUSTMENTS WERE MADE TO INCOME TAX EXPENSE IN THE FUTURE TEST YEAR?

A. The income tax expense calculation in the Future Test Year has been adjusted for the following:

- non-deductible permanent book/tax differences including club dues, political contributions, and lobbying expense;
- the flow-through difference for AFUDC Equity;
- Federal and State Excess Deferred Income Tax reversals as follows:
    - the ARAM reversal of Federal Excess Deferred Income Taxes has been calculated using the current estimated useful lives in accordance with IRS normalization requirements; and
    - the Excess Deferred State Income Tax amortization has been calculated based on a 33-year amortization of the estimated balance as of December 31, 2017.

All the above changes are shown on Rule 630 Schedules H-9, and the changes to taxable income are shown on Rule 630 Schedule H-10.

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. 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. WILL CUSTOMERS BE HARMED BY THE RETURN OF EXCESS DEFERRED STATE INCOME TAXES OVER THE 33-YEAR AMORTIZATION PERIOD?

A. No, they will not. Just as with any other ADIT liability, the excess deferred state income taxes reduce rate base because they are a component of ADIT. This compensates customers for the difference in timing between when tax expense is recovered from customers and when it is paid out by NMGC. The excess deferred state income taxes will only be removed from the ADIT liability which reduces rate base when they are actually returned to customers. Therefore, customers are not harmed by any delay. The only difference between the excess deferred state income taxes and other ADIT is that NMGC will return the excess deferred state income taxes to customers through its rates and will pay other ADIT to the IRS. Either way, customers are compensated or "made whole" for the entire time that NMGC has the use of the excess funds. This is a basic tenet of ratemaking for noncash expenses, including ADIT, and is the very reason that the ADIT liability is included as a reduction to rate base.

Q. ARE THE EXCESS DEFERRED TAXES A SOURCE OF ZERO-COST CAPITAL TO NMGC?

A. No. Deferred taxes can be seen only as a cost-free source of capital that comes from the taxing authority. By no means are they cost-free to NMGC once the ratemaking implications are considered. Because NMGC received this payment deferral from the taxing authority at no cost, the Company must reduce rate base by the resulting ADIT liability. This compensates customers for the non-cash portion of recoverable income tax expense and reduces revenues earned by the Company. This reduction in revenue is NMGC's cost, and the benefit of deferred taxes is passed back to customers through the ADIT rate base reduction.

Q. DO YOU HAVE ANY CONCLUDING OBSERVATIONS?

A. Yes, I do:

- the ADIT and income tax expense included in the Base Period and Future Test Year 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 Future Test Year adjustments and ARAM excess deferred income tax amortization ensure compliance with the IRS normalization requirements for those items. The Future Test Year

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 NMGC filings; and
- the income tax calculations are all done on a stand-alone Company basis, consistent with previous NMGC filings.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.