PRE-FILED DIRECT TESTIMONY

OF AARON J. BJORKMAN

ON BEHALF OF NORTHWESTERN ENERGY

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Witness Information

Q. Please provide your name, employer, and title.

A. My name is Aaron J. Bjorkman, and I am NorthWestern Energy's ("NorthWestern") Director - Corporate Taxes. I am responsible for all tax related compliance, research, and planning activities for NorthWestern.

Q. Please provide a description of your relevant employment experience and other professional qualifications.

A. I have over 20 years of experience in the field of corporate taxation, 13 years of which I spent working in the public utility sector with NorthWestern. Prior to my employment at NorthWestern, I worked as a Certified Public Accountant for Deloitte and for RSM, spending the majority of my time on corporate taxation. I have a Bachelor of Science degree in Accounting and a Master's in Professional Accountancy from the University of South Dakota.

Purpose of Testimony

Q. What is the purpose of your testimony in this docket?

A. I provide testimony in support of all income and property tax related items included in this filing. All income and property tax items in both the electric and natural gas income statements and rate base exhibits were prepared under my supervision and control. I sponsor Statement J - Income Taxes as required in ARM 38.5.169 and Statement K - Taxes other than Income as required in ARM 38.5.173.

<u>Income Taxes</u>

Q. Have income taxes in this filing been calculated in a manner consistent with the methodology approved by the Montana Public Service Commission ("Commission" or "MPSC") in prior rate proceedings?

A. Yes. The income taxes included in this filing have been calculated utilizing the partial flow-through method that the Commission has approved in prior dockets. Partial flow-through was required as part of Final Order No. 5709d in Docket No. 93.6.24 filed by The Montana Power Company and has continued to be used in recent dockets. Plant-related tax adjustments, except for those subject to mandatory normalization under Section 168 of the Internal Revenue Code ("IRC"), are generally flowed through to customers as a reduction to the income tax expense included in the revenue requirement.

The items included as flow-through in this docket are shown on Statement J – Workpapers B ("Stmt J Wkpr B"), pages 1 through 4, lines 49-Bad Debt Expense, 51-Meters, 53-Repairs Expense, 57-Accelerated Depreciation-BLM (Book Life Method) Tax vs. Book Depreciation, and 59-Removal Costs. Because these temporary items do not have an offsetting deferred income tax expense impact in Stmt J Wkpr B as the other items on lines 19-29 do, the flow-through of tax benefits to recoverable income tax expense and customer rates results. Put differently, rather than a deferred tax impact, the offset is recorded as a Regulatory Asset to be recovered from customers at a future time when the tax position reverses. Because the offset is to a balance sheet Regulatory Asset instead of deferred income tax expense, these flow-through items reduce overall tax expense, which, in turn, reduces the revenue requirement to customers.

Q. Have the impacts of the Tax Cuts and Jobs Act ("TCJA") been reflected in this filing?

A. Yes. For the electric segment, TJCA methodologies established in Docket No. 2018.02.012 are continued as part of this rate review. The natural gas portion of TCJA included in this filing is utilizing the established methodologies from electric Docket No. 2018.02.012 with respect to amortization of Excess/Deficient Deferred Income Taxes ("EDIT"). Those methodologies are computed at Stmt J Wkpr B lines 13-15 and are detailed in the discussion on deferred income taxes, as discussed below.

Electric Income Taxes

Q. Please explain all of the provisions for deferred income taxes.

A. The details of the deferred income taxes are shown in the Electric Statement J workpapers. I describe below the deferrals shown in that statement:

Amortization of Excess/Deficient Deferred Income Taxes – Plant

Protected Plant EDIT from the TCJA results from income tax accelerated depreciation of public utility property that is subject to the normalization restriction in the IRC. The Internal Revenue Service ("IRS") requires a public utility to amortize Protected EDIT using the Average Rate Assumption Method ("ARAM"), if possible. NorthWestern utilized this amortization method for all items that have underlying book depreciation assets within our depreciation software. Under ARAM, the amortization of EDIT begins when the amount of tax depreciation taken with respect to each asset is less than the amount of the book depreciation with respect to the asset.

For Protected Plant items without corresponding book basis, NorthWestern amortizes EDIT over the average remaining book lives of the corresponding asset classes.

Electric Protected Plant EDIT decreased deferred income tax expense by $1,436,647 as shown in Stmt J Wkpr B, page 2, line 13.

<u>Amortization of Excess/Deficient Deferred Income Taxes - NOL</u>

A net operating loss ("NOL") occurs when a company's allowable tax deductions exceed its taxable income, resulting in negative taxable income. The NOL amounts are considered "protected", for example as provided in a series of private letter rulings ("PLR") issued by the IRS including PLR 202206010, as the NOLs were driven by the excess of tax over book depreciation. There are no remaining NOL carryovers for income tax purposes impacting rate base in this filing; however there continues to be amortization of the protected NOL EDIT that originated as part of TCJA. The protected NOL EDIT were not related to specific underlying public utility property and therefore using ARAM to amortize the amounts is not possible. The amounts are being amortized based on the average book lives of the public utility property at the time of TCJA. The average period of amortization is approximately 33 to 40 years.

The Electric Protected NOL EDIT increased deferred income tax expense by $922,398 as shown in Stmt J Wkpr B, page 2, line 14.

<u>Amortization of Excess/Deficient Deferred Income Taxes - Unprotected Non-Plant</u>

Unprotected Non-Plant EDIT results from tax timing differences that are not protected pursuant to IRS normalization rules and are not subject to flow-through by Commission precedent. Because the IRC does not require Unprotected Non-Plant EDIT to be normalized, this EDIT may be amortized. NorthWestern elects to amortize Unprotected Non-Plant EDIT over a five-year straight line amortization period, as established by the electric rate review Docket No. 2018.02.012, and adjusts rate base to reflect the amortization.

Electric Unprotected Non-Plant EDIT amortization increased deferred income tax expense by $1,376,844 as shown in Stmt J Wkpr B, page 2, line 15.

Amortization of Investment Tax Credit

NorthWestern receives investment tax credits that are subject to the normalization rules under IRC Section 168(i)(9) and former IRC Section 46(f). Therefore, the credits received are amortized because they must be reflected in cost of service for ratemaking purposes over the period of time used in computing depreciation expense.

Electric Amortization of investment credit decreased deferred income tax expense by $129,482 as shown in Stmt J Wkpr B, page 2, line 16.

Amortization of Regulatory Asset-Removal Costs

As explained in more detail in testimony below, NorthWestern has inadvertently provided tax benefits resulting from incurred removal costs to customers without recovering the associated deferred tax expense as the temporary difference originates in book depreciation. Because customers realize those benefits at the end of asset life, a Regulatory Asset has been building within the FAS 109 Regulatory Assets that will not reverse naturally by a future event. As discussed in more detail below, NorthWestern proposes to amortize the removal costs recorded within the FAS 109 Regulatory Asset over 10 years.

Electric Removal cost amortization increased deferred income tax expense by $1,924,820 as shown in Stmt J Wkpr B, page 2, line 17.

Injuries and Damages

For book purposes, NorthWestern accrues expenses for personal injuries and damages based on actuarial studies. For income tax purposes, NorthWestern deducts these expenses when paid.

NorthWestern accrued $688,965 (Stmt J Wkpr B, page 3, line 63, Column V) less than it paid for these electric expenses. NorthWestern recognized an increase to deferred income tax expense of $181,422 (Stmt J Wkpr B, page 1, line 19, Column V) to account for the temporary difference and reduced rate base by the same amount.

<u>Environmental Reserve</u>

For book purposes, NorthWestern accrues expenses for environmental costs based upon estimated costs of future environmental remediation. For income tax purposes, NorthWestern deducts these expenses when paid.

NorthWestern accrued $346,317 (Stmt J Wkpr B, page 3, line 62, Column V) less than it paid for these electric expenses. NorthWestern recognized an increase to deferred income tax expense of $91,194 (Stmt J Wkpr B, page 1, line 29, Column V) to account for the temporary difference and decreased rate base by the same amount.

<u>Accrued Incentive Compensation</u>

NorthWestern uses incentive pay plans for all employees as part of their compensation package. NorthWestern accrues incentive pay during the current year, but pays it in March of the following year. For income tax purposes, NorthWestern deducts these expenses when paid.

NorthWestern accrued $1,648,818 (Stmt J Wkpr B, page 3, line 54, Column V) more than it paid for these electric expenses. NorthWestern recognized a decrease to deferred income tax expense of $434,175 (Stmt J Wkpr B, page 1, line 21, Column V) to account for the temporary difference and increased rate base by the same amount.

Accelerated Depreciation

For federal income tax purposes, NorthWestern uses accelerated tax depreciation. For calculating deferred income taxes, NorthWestern uses normalized tax depreciation computed using book lives and book methods applied to the tax basis of assets. The IRC and IRS regulations require that NorthWestern calculate deferred taxes this way to remain qualified to use accelerated methods of tax depreciation on its federal tax return.

NorthWestern's Electric tax depreciation exceeded its normalized tax depreciation by $49,715,947 (Stmt J Wkpr B, page 3, line 58, Column A). Known and measurable adjustments, most notably 2022 forecasted plant adjustments, decreased the $49,715,947 excess depreciation by $235,868 (Stmt J Wkpr B, page 4, line 58, Column U) to $49,480,079 (Stmt J Wkpr B, page 4, line 58, Column V). Deferred federal income tax expense increased by $10,440,349 (Stmt J Wkpr B, page 1, line 22, Column A). Deferred income tax expenses were then decreased by $49,532 (Stmt J Wkpr B, page 2, line 22, Column U) resulting in a net deferred income tax expense increase of $10,390,817 (Stmt J Wkpr B, page 2, line 22, Column V).

__Customer Advances for Construction and Contributions In Aid of Construction__

When NorthWestern collects a Contribution in Aid of Construction ("CIAC") or a Customer Advance for Construction ("CAC") from customers, the booked capitalized plant costs are reduced by the amount collected. For income tax purposes, the IRS considers the amount collected to be taxable income to NorthWestern and the tax basis of the capitalized plant costs is increased for tax depreciation purposes. In Order No. 5236c in Docket No. 86.11.62, the Commission determined that the cost causer, not all customers, should bear the costs associated with the taxability of CIAC and CAC. To recover the costs associated with the current tax liability related to receipt of CIAC and CAC, which is subsequently recovered through tax depreciation deductions in future years, NorthWestern is allowed to collect a surcharge from the party requesting the extension of service facilities. The surcharge reduces rate base and book depreciation charged to all customers. The deferred taxes related to CIAC and CAC serve to offset the current taxes related to CIAC and CAC to ensure that customers are not charged for amounts for which they are not responsible.

NorthWestern recognized Electric CIAC and CAC taxable income of $12,641,123 (Stmt J Wkpr B, page 3, line 52, Column V). NorthWestern recognized a decrease to deferred income tax expense of $3,328,723

(Stmt J Wkpr B, page 1, line 26, Column V) and increased rate base by the same amount.

Financial Accounting Standards (FAS) 106 and 112 Post Retirement Benefits

NorthWestern accounts for post-retirement and post-employment healthcare and pension benefits under the accrual method. For income tax purposes, Northwestern deducts these expenses as they are paid.

NorthWestern accrued $1,736,232 (Stmt J Wkpr B, page 3, line 61, Column V) more than it paid for these electric expenses. NorthWestern recognized a decrease to deferred income tax expense of $457,193 (Stmt J Wkpr B, page 1, line 27, Column V) to account for the temporary difference and increased rate base by the same amount.

Costs of Refinancing Debt

NorthWestern generally accounts for costs related to the refinancing of its old debt by amortizing those costs over the term of the new debt. For income tax purposes, NorthWestern deducts these costs in the year incurred.

NorthWestern deducted $141,874 (Stmt J Wkpr B, page 3, line 56, Column V) more than it amortized for these electric costs. NorthWestern recognized an increase to deferred income tax expense of $37,359 (Stmt J Wkpr B, page 1, line 28, Column V) to account for the temporary difference and reduced rate base by the same amount.

Deferred Revenue

NorthWestern defers for book purposes certain revenues related to transmission reservations or access feasibility studies, etc. For income tax purposes, NorthWestern recognizes these revenues when they are received.

NorthWestern recognized book deferred revenue in the amount of $12,687,483 (Stmt J Wkpr B, page 3, line 60, Column V) more than recorded tax revenue. NorthWestern recognized an increase to deferred income tax expense of $3,340,931 (Stmt J Wkpr B, page 1, line 25, Column V) to account for the temporary difference and decreased rate base by the same amount.

MPSC and Montana Consumer Counsel ("MCC") Taxes

NorthWestern defers for book purposes differences between MPSC and MCC taxes collected in revenue versus the amount of MPSC and MCC taxes paid. For income tax purposes, NorthWestern recognizes these revenues as taxable income when they are received, and these taxes are deducted when paid.

NorthWestern paid $793,086 (Stmt J Wkpr B, page 3, line 55, Column V) less than it accrued for these electric expenses. NorthWestern recognized a decrease to deferred income tax expense of $208,839 (Stmt J Wkpr B, page 1, line 24, Column V) to account for the temporary difference and increased rate base by the same amount.

Q. Please further explain the Income Tax Adjustment Columns.

A. The Income Tax Adjustment columns on Electric Stmt J Wkpr B, line 49, Column S and on the Electric Statement G Income Statements include an adjustment for the bad debt expense flow-through for income taxes. As discussed in the Pre-filed Direct Testimony of Andrew D. Durkin, NorthWestern excluded uncollectible expenses for 2020 and 2021 from uncollectible accounts adjustment. As such, there is an adjustment to the average 2017 to 2019 bad debt expense flow-through taxes of $2,188,561 for electric.

Q. Please further explain the Interest Synchronization Adjustment Columns.

A. The Interest Synchronization Adjustment column on Electric Stmt J Wkpr B, Column T and on the Statement G Income Statements synchronizes rate base and weighted cost of debt for computing the interest expense deduction included in the income tax expense computation in compliance with long-standing Commission-mandated policy. This ensures customers are not charged any income tax expense impacts due to recovery of deductible interest expense.

Q. Please explain the income tax portions of the Electric Stmt J Wkpr B, lines 13-29 and lines 48-66, Column Q, 2022 Forecasted plant adjustment column.

A. These adjustments represent the income tax impacts as a result of the 2022 known and measurable plant-related items as discussed in the Pre-filed Direct Testimony of Jeffrey B. Berzina. As with the underlying 2022 forecasted plant adjustments, NorthWestern will true up the income tax impacts to those adjustments using 2022 actual impacts at the time of NorthWestern's rebuttal filing.

Natural Gas Income Taxes

Q. Please explain all of the provisions for deferred income taxes.

A. The details of the Natural Gas deferred income taxes are shown in the Natural Gas Statement J workpapers. I describe below the deferrals shown in that statement:

Amortization of Excess/Deficient Deferred Income Taxes – Plant

As discussed above in the Electric section of my testimony, Protected Plant EDIT from the TCJA results from income tax accelerated depreciation of public utility property that is subject to the normalization restriction in the IRC.

Natural Gas Protected Plant EDIT decreased deferred income tax expense by $756,106 as shown in Stmt J Wkpr B, page 2, line 13.

Amortization of Excess/Deficient Deferred Income Taxes - Unprotected Non-Plant

As discussed above in the Electric section of my testimony, NorthWestern elects to amortize Unprotected Non-Plant EDIT over a five-year straight line amortization period, as established by the electric rate review Docket No. 2018.02.012. NorthWestern adjusts rate base to reflect this amortization.

Natural Gas Unprotected Non-Plant EDIT amortization increased deferred income tax expense by $269,040 as shown in Stmt J Wkpr B, page 2, line 15.

Amortization of Regulatory Asset-Removal Costs

As discussed above and explained in more detail in testimony below, NorthWestern has inadvertently provided tax benefits resulting from incurred removal costs to customers without recovering the associated deferred tax expense as the temporary difference originates in book depreciation. Because customers realize those benefits at the end of asset life, a

Regulatory Asset has been building within the FAS 109 Regulatory Assets that will not reverse naturally by a future event. As discussed in more detail below, NorthWestern proposes to amortize the removal costs recorded within the FAS 109 Regulatory Asset over 10 years.

Natural Gas removal cost amortization increased deferred income tax expense by $290,082 as shown in Stmt J Wkpr B, page 2, line 17.

Injuries and Damages

For book purposes, NorthWestern accrues expenses for personal injuries and damages based on actuarial studies. For income tax purposes, NorthWestern deducts these expenses when paid.

NorthWestern accrued $267,931 (Stmt J Wkpr B, page 3, line 63, Column R) less than it paid for these natural gas expenses. NorthWestern recognized an increase to deferred income tax expense of $70,553 (Stmt J Wkpr B, page 1, line 19, Column R) to account for the temporary difference and reduced rate base by the same amount.

Environmental Reserve

For book purposes, NorthWestern accrues expenses for environmental costs based upon estimated costs of future environmental remediation.

For income tax purposes, NorthWestern deducts these expenses when paid.

NorthWestern accrued $134,679 (Stmt J Wkpr B, page 3, line 62, Column R) less than it paid for these natural gas expenses. NorthWestern recognized an increase to deferred income tax expense of $35,464 (Stmt J Wkpr B, page 1, line 29, Column R) to account for the temporary difference and decreased rate base by the same amount.

<u>Accrued Incentive Compensation</u>

Again, NorthWestern uses incentive pay plans for all employees as part of their compensation package. NorthWestern accrues incentive pay during the current year, but pays it in March of the following year. For income tax purposes, NorthWestern deducts these expenses when paid.

NorthWestern accrued $641,207 (Stmt J Wkpr B, page 3, line 54, Column R) more than it paid for these natural gas expenses. NorthWestern recognized a decrease to deferred income tax expense of $168,846 (Stmt J Wkpr B, page 1, line 21, Column R) to account for the temporary difference and increased rate base by the same amount.

Accelerated Depreciation

For federal income tax purposes, NorthWestern uses accelerated tax depreciation. For calculating deferred income taxes, NorthWestern uses normalized tax depreciation computed using book lives and book methods applied to the tax basis of assets. The IRC and IRS regulations require that NorthWestern calculate deferred taxes this way to remain qualified to use accelerated methods of tax depreciation on its federal tax return.

NorthWestern's natural gas tax depreciation exceeded its normalized tax depreciation by $2,532,214 (Stmt J Wkpr B, page 3, line 58, Column A). Known and measurable adjustments, most notably 2022 forecasted plant adjustments, decreased the $2,532,214 excess tax depreciation by $2,913,947 (Stmt J Wkpr B, page 4, line 58, Column Q) to an amount of normalized depreciation exceeding tax depreciation by $381,734 (Stmt J Wkpr B, page 4, line 58, Column R). Deferred federal income tax expense increased by $531,765 (Stmt J Wkpr B, page 1, line 22, Column A). Deferred income tax expenses were then decreased by $611,929 (Stmt J Wkpr B, page 2, line 22, Column Q) resulting in a net deferred income tax expense decrease of $80,164 (Stmt J Wkpr B, page 2, line 22, Column R).

Customer Advances for Construction and Contributions In Aid of Construction

As discussed above in the Electric section of my testimony, when NorthWestern collects a CIAC or a CAC from customers, the booked capitalized plant costs are reduced by the amount collected. The deferred taxes related to CIAC and CAC serve to offset the current taxes related to CIAC and CAC to ensure that customers are not charged for amounts for which they are not responsible.

NorthWestern recognized natural gas CIAC and CAC taxable income of $504,193 (Stmt J Wkpr B, page 3, line 52, Column R). NorthWestern recognized a decrease to deferred income tax expense of $132,767 (Stmt J Wkpr B, page 1, line 26, Column R) and increased rate base by the same amount.

Financial Accounting Standards (FAS) 106 and 112 Post Retirement Benefits

NorthWestern accounts for post-retirement and post-employment healthcare and pension benefits under the accrual method. For income tax purposes, NorthWestern deducts these expenses as they are paid.

NorthWestern accrued $675,201 (Stmt J Wkpr B, page 3, line 61, Column R) more than it paid for these natural gas expenses. NorthWestern recognized a decrease to deferred income tax expense of $177,798 (Stmt

J Wkpr B, page 1, line 27, Column R) to account for the temporary difference and increased rate base by the same amount.

Costs of Refinancing Debt

NorthWestern generally accounts for costs related to the refinancing of its old debt by amortizing those costs over the term of the new debt. For income tax purposes, NorthWestern deducts these costs in the year incurred.

NorthWestern deducted $55,173 (Stmt J Wkpr B, page 3, line 56, Column R) more than it amortized for these natural gas expenses. NorthWestern recognized an increase to deferred income tax expense of $14,529 (Stmt J Wkpr B, page 1, line 28, Column R) to account for the temporary difference and reduced rate base by the same amount.

Deferred Revenue

NorthWestern defers for book purposes certain revenues related to transmission reservations or access feasibility studies, etc. For income tax purposes, NorthWestern recognizes these revenues when they are received.

NorthWestern recognized natural gas book deferred revenue in the amount of $4,934,021 (Stmt J Wkpr B, page 3, line 60, Column R) more than recorded tax revenue. NorthWestern recognized an increase to deferred income tax expense of $1,299,251 (Stmt J Wkpr B, page 1, line 25, Column R) to account for the temporary difference and decreased rate base by the same amount.

MPSC and Montana Consumer Counsel ("MCC") Taxes

NorthWestern defers for book purposes differences between MPSC and MCC taxes collected in revenue versus the amount of MPSC and MCC taxes paid. For income tax purposes, NorthWestern recognizes these revenues as taxable income when they are received, and these taxes are deducted when paid.

NorthWestern paid $349,981 (Stmt J Wkpr B, page 3, line 55, Column R) less than it accrued for these natural gas expenses. NorthWestern recognized a decrease to deferred income tax expense of $92,159 (Stmt J Wkpr B, page 1, line 24, Column R) to account for the temporary difference and increased rate base by the same amount.

Q. Please further explain the Income Tax Adjustment Columns.

A. The Income Tax Adjustment columns on Natural Gas Stmt J Wkpr B, line 49, Column O, and on the Natural Gas Statement G Income Statements include an adjustment for the bad debt expense flow-through for income taxes. As discussed by Mr. Durkin, NorthWestern excluded uncollectible expenses for 2020 and 2021 from the uncollectible accounts adjustment. As such, there is an adjustment to the average 2017 to 2019 bad debt expense flow-through taxes of $851,107 for natural gas.

Q. Please further explain the Interest Synchronization Adjustment Columns.

A. The Interest Synchronization Adjustment column on Natural Gas Stmt J Wkpr B, Column P and on the Natural Gas Statement G Income Statements synchronizes rate base and weighted cost of debt for computing the interest expense deduction included in the income tax expense computation in compliance with long-standing Commission-mandated policy. This ensures customers are not charged any income tax expense impacts due to recovery of deductible interest expense.

Q. Please explain the income tax portions of the Natural Gas Stmt J Wkpr B, lines 13-29 and lines 48-66 Column J 2022 Forecasted plant adjustment column.

A. These adjustments represent the income tax impacts as a result of the 2022 known and measurable plant-related items as discussed by Mr. Berzina. As with the underlying 2022 forecasted plant adjustments, NorthWestern will true up the income tax impacts to those adjustments using 2022 actual impacts at the time of NorthWestern's rebuttal filing.

Proration of Accumulated Deferred Income Tax Balances

Q. Do the Accumulated Deferred Income Tax ("ADIT") balances for electric and natural gas include an adjustment to reflect the proration formula required by the normalization regulations when the effective date of rates precedes the end of the test period?

A. Yes. It is not likely that NorthWestern will have a proration requirement in this rate filing. If the rates, including interim rates, become effective in 2022, and those rates include forecasted plant, NorthWestern will need to recompute rate base to comply with the requirements of Treasury Regulation Section 1.167(l)-1(h)(6). Although NorthWestern has requested that interim rates be effective on October 1, 2022, forecasted plant has been removed from interim requested rates. As a result proration will not likely be necessary.

Cost of Removal and Salvage Change

Q. Please explain the adjustments made within the electric and natural gas 2022 forecasted plant with respect to the tax accounting related to removal and salvage costs.

A. In order to explain, I will first discuss the current accounting for these costs. NorthWestern is currently analyzing the treatment of its deferred tax accounting for the temporary book/tax differences related to the estimated cost of removing depreciable plant after its retirement and the estimated salvage value at such time in light of recent PLRs issued by the IRS.

NorthWestern accrues both future costs of removals (“COR”) as well as future salvage value (herein referred to as “net COR”) as a component of the overall book depreciation expense recorded for regulatory and financial accounting. Accrued cost of removals (within book depreciation) results in an increase in book depreciation expense in NorthWestern’s regulatory books of account. NorthWestern does not receive a tax deduction for cost of removals until the cost is incurred at the end of life disposition of the asset. Accrued salvage (also within book depreciation) results in a decrease of book depreciation expense in NorthWestern’s regulatory books of account. NorthWestern is subject to taxation on salvage amounts received upon end of life disposition of the asset.

Overall, the accrual of net COR has been creating a net deferred tax asset over the life of the assets. The accrued net COR was not separately accounted for from accrued book depreciation within NorthWestern’s book depreciation software until late 2013 and NorthWestern has never separated accrued salvage from accrued removal costs within the book depreciation software. The tax software has only utilized the accrued portion of net COR in 2013 and 2014 and has otherwise continued to include net COR as part of book depreciation expense in the accumulation of overall deferred taxes.

Pursuant to the partial flow-through requirement of Docket No. 93.6.24, Final Order No. 5709d, NorthWestern has been treating the incurred net COR as a flow-through item. However, since accrued net COR has been combined with book depreciation, those deferred taxes have inadvertently not received flow-through treatment, but instead have been normalized. This mismatched tax accounting continues to build a regulatory asset at the end of the asset lives as customers have been receiving benefits of incurred net COR, but have not been paying these expenses as the net COR was being accrued. That regulatory asset does not currently have an automated mechanism within the tax software to reverse over time since the regulatory asset has been created at end of life with no adjustments to the regulatory asset during the life of the property creating the book to tax differences.

Based on recent PLRs, including PLR 202033002, PLR 202124003, PLR 202141001, PLR 202150003, and ultimately leading up to PLR 202211004 (attached as Exhibits AJB-1 through AJB-5), accrued and incurred cost of removals are not subject to normalization; however accrued and received salvage is subject to normalization. In PLR 202141001, the IRS stated that:

> 1) Taxpayer's Deferred Tax Asset ("DTA") for cumulative timing differences between (a) recognition of accrued gross COR with respect to public utility property as an increase in depreciation expense in its regulatory books of account and (b) the subsequent tax deduction of such costs upon disposition is not subject to the normalization rules of Code Section 168(i)(9) and the associated excess deferred tax amount is not subject to the normalization rules of TCJA Section 13001(d).
>
> 2) Taxpayer's Deferred Tax Liability ("DTL") for cumulative timing differences between (a) recognition of accrued gross salvage value with respect to public utility property as a reduction of depreciation expense in its regulatory books of account and (b) the subsequent taxation of such salvage amounts upon disposition is subject to the normalization rules of Code Section 168(i)(9) and the associated excess deferred tax amount is subject to the normalization rules of TCJA Section 13001(d) regardless of whether the gross salvage value timing differences are partially or fully offset by gross COR timing differences and whether the DTL related to gross salvage value differences is partially or fully offset by the DTA for gross COR differences.

The PLR clearly provides that deferred taxes with respect to gross COR temporary differences <u>are not</u> subject to the normalization requirements and that deferred taxes attributable to gross salvage value temporary differences <u>are</u> subject to the normalization rules. Therefore, COR is allowed flow-through treatment, but salvage is "protected" and therefore is not allowed for flow-through treatment.

In addition, PLR 202211004 specifically addresses TCJA EDIT:

> As described, section 13001(d)(1) provides that a normalization method of accounting shall not be treated as being used if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the EDIT more

rapidly or to a greater extent than such reserve would be reduced under the ARAM. ARAM is defined, in part, under section 13001(d)(3)(B) as the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property. Commission A's method results in the recovery of EDIT over a shorter period than the remaining life of the property. Simply stated, the annual timing difference reversal provided in Commission A's method is overstated by the COR which is not included in the aggregate timing differences for the property at the beginning of the year. Rather than only establishing a new deferred tax asset for a new COR accrued for books, the new COR also is used to accelerate the recovery of the EDIT. This violates the Normalization Rules in section 13001 of the TCJA.

While COR is taken into account as an element of book composite depreciation, COR does not produce a timing difference that represents the type of timing difference that is protected by the normalization rules. The COR portion in book composite depreciation represents a timing difference that will reverse when the tax benefit is realized at the time the COR is incurred. ARAM controls the return of tax expense collected from customers for which Taxpayer already has received an accelerated tax benefit, which tax benefit will not be repaid to the government as a result of the corporate rate reduction. While Taxpayer included the tax benefit of COR in cost of service, Taxpayer receives no tax benefit from the government for COR until the asset is removed from service. Any accumulated excess deferred tax asset attributable to COR represents deferred tax benefits Taxpayer has provided to customers at the 35 percent corporate tax rate, which now are expected to produce only a 21 percent current tax benefit for Taxpayer when realized as a result of the corporate tax rate reduction. While the method by which Taxpayer is permitted to recover this excess deferred tax benefit that it already has provided to customers is not governed by the Normalization Rules, those Normalization Rules do not contemplate COR timing differences accelerating the return of EDIT to customers, which is protected under the Normalization Rules.

Based on the above PLR guidance, NorthWestern's historical ratemaking and regulatory reporting of deferred taxes for net COR and its reversal of protected EDIT is not consistent with the applicable normalization requirements. Specifically, NorthWestern currently treats reversing salvage value temporary differences as flow-through items and amortizes protected EDIT more quickly than permitted under ARAM.

For the reasons summarized above, NorthWestern must prospectively adjust its deferred tax accounting for the salvage value component of net COR incurred and the reversal of Protected Plant EDIT to become compliant with the applicable normalization requirements and avoid the sanctions for violation of such rules.

To that end, NorthWestern has made the following adjustments as part of the 2022 forecast plant adjustments in order to comply with IRS normalization rules:

1. NorthWestern will no longer combine accrued COR with book depreciation. As a result, the following will be impacted:
    a. There will no longer be an excess amount of book depreciation resulting in an amount of Protected Plant EDIT reversing under ARAM in excess of the amount permitted under the normalization rules.

b. Accrued COR (i.e., an originating book/tax difference) will prospectively receive flow-through treatment as prescribed by Final Order No. 5709d of Docket No. 93.6.24 and a more appropriate matching of the tax effects of accrued COR and incurred COR will occur.

2. NorthWestern will no longer net estimated salvage within accrued COR. Accrued salvage has not historically been provided to NorthWestern as part of previous depreciation studies. However, NorthWestern will engage a third-party consultant to estimate the portion of accrued salvage within the overall accrued net COR. NorthWestern will continue to normalize the originating salvage value book/tax differences.
3. NorthWestern will no longer combine salvage value received into net COR incurred and will instead prospectively normalize salvage value received (i.e., a reversing book/tax difference).
4. NorthWestern proposes to recover the regulatory asset that has resulted from recording net COR under the flow-through method but recording the accrual of net COR under the normalization method evenly over 10 years beginning with the effective date of the rates.

Q. What are the consequences if NorthWestern does not comply with the deferred tax normalization requirements, including the rules related to TCJA excess deferred taxes, as discussed above?

A. If NorthWestern does not comply with the deferred tax normalization requirements, it will prospectively lose the right to deduct accelerated depreciation. Instead, tax depreciation will equal regulatory depreciation expense for public utility property subject to regulation by the Commission that is in service at the time of the violation or placed in service after the violation occurs.

Property Taxes Adjustment

Q. Please explain the amount included in this filing as an adjustment for property taxes.

A. This docket will reset the base used annually in the property tax tracker dockets. The most recent property tax tracker docket was Docket No. 2021.11.129. The Statement G income statements include a column labeled "Taxes-Other Than Income Adjustment" that presents the adjustment for property taxes. The 2022 estimated property taxes included in the electric and natural gas filing have been calculated by increasing the 2020 actual taxes by 3.326%. NorthWestern will update to its actual 2022 property tax expense when it files rebuttal testimony in this proceeding to reflect changes that will be known at that time, which is consistent with prior Commission practice. The test period computation of property tax expense is shown in Statement G.

Q. Does this conclude your testimony?

A. Yes, it does.

VERIFICATION

This Pre-filed Direct Testimony of Aaron J. Bjorkman is true and accurate to the best of my knowledge, information, and belief.

/s/ Aaron J. Bjorkman
Aaron J. Bjorkman