Prefiled Direct Testimony
Aaron J. Bjorkman

Before the South Dakota Public Utilities Commission
of the State of South Dakota

In the Matter of the Application of
NorthWestern Corporation, d/b/a NorthWestern Energy

For Authority to Increase Electric Utility Rates
in South Dakota

Docket No. EL23-_____

June 15, 2023

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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" or "Company") 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, 15 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.

Q. Have you previously testified before the South Dakota Public Utilities Commission ("Commission" or "SD PUC")?

A. No, however I have testified in multiple dockets in other jurisdictions.

Purpose of Testimony

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

A. I provide testimony in support of income tax-related items included in this filing. All income tax items in both the income statements and rate base exhibits were prepared under my supervision and control. I am sponsoring Statement K - Income Taxes.

Income Taxes

Q. Have income taxes in this filing been calculated in a manner consistent with the methodology approved by the Commission 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 utilized as part of recent dockets, including EL14-106 and GE17-003. 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.

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

A. Yes. The TCJA methodologies related to Excess/Deficient Deferred Income Taxes (“EDIT”) as established in Docket No. GE17-003 are continued as part of this rate review.

Rate Base Deferred Taxes

Q. What are deferred income taxes?

A. Deferred taxes are differences between the book and tax treatment for certain transactions. Accelerated tax depreciation generally exceeds book depreciation during the early years of an asset's service life, creating an accumulated deferred income tax liability.

Q. Why are certain deferred income taxes a reduction to rate base?

A. Since deferred income taxes are typically liabilities for taxes due in future periods, they represent a source of funds. Accordingly, the average accumulated deferred income tax liability balance is deducted from rate base to recognize such funds are available for NorthWestern to use between the time they are collected in rates from customers and the time they are eventually remitted to the government.

Q. Please explain how deferred taxes related to Production Tax Credits ("PTCs") are being reflected in rate base.

A. Deferred tax assets ("DTA") are related to PTCs, which have been provided to customers through NorthWestern's Delivered Cost of Fuel Adjustment Computation ("Fuel Tracker") as they are earned. This occurs even though the PTCs have not yet been utilized and monetized by NorthWestern, primarily due to its historical net operating loss ("NOL") created as a result of many years of accelerated bonus tax depreciation enacted by legislation. Although NorthWestern no longer has any remaining NOLs, PTC DTAs have not yet been fully utilized. Because the DTAs related to PTCs have been provided to customers, but the PTCs have not yet been monetized by NorthWestern, these PTC DTAs should be included in rate base. Including the PTC DTAs in rate base corrects an inequity that has distorted historical recovery relative to the Company's balance sheet.

Including PTCs in rate base is analogous to the Company adjusting rate base for plant-related normalized depreciation deferred tax liabilities ("DTL"). In the case of the plant-related DTL, the Company reduces rate base as a "credit" because otherwise it is effectively receiving an interest-free loan for the accelerated tax depreciation that occurs. PTCs and the resulting PTC DTAs only exist because of the presence of the underlying generation facility assets that create plant-related DTLs that reduce rate base. The PTC DTA could be viewed as a reduction to the plant-related DTL, or "credit."

Cost of Removal and Salvage Change

Q. Please explain the adjustments made with respect to the tax accounting related to removal and salvage costs.

A. In order to explain this adjustment, 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 Private Letter Rulings ("PLR") issued by the Internal Revenue Service ("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 COR (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 COR 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 DTA 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 methodology addressed earlier in my testimony, NorthWestern has been treating the <u>incurred</u> net COR as a flow-through item. However, since <u>accrued</u> 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[1], accrued and incurred CORs 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

[1] Private Letter Rulings referenced can be found at:
202033002.pdf (irs.gov), https://www.irs.gov/pub/irs-wd/202033002.pdf
202124003.pdf (irs.gov), https://www.irs.gov/pub/irs-wd/202124003.pdf
202141001.pdf (irs.gov), https://www.irs.gov/pub/irs-wd/202141001.pdf
202150003.pdf (irs.gov), https://www.irs.gov/pub/irs-wd/202150003.pdf
202211004.pdf (irs.gov). https://www.irs.gov/pub/irs-wd/202211004.pdf

> 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 normalizing 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 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 has engaged a third-party consultant to compute 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.

Q. Does this complete your testimony?

A. Yes, it does.